PRACTICAL

BOOK-KEEPING

AND

ACCOUNTANCY

A COMPREHENSIVE GUIDE

TO THE KEEPING OF PRESENT-DAY

BUSINESS ACCOUNTS

by

L. J. NORTHCOTT, F.C.A.

and

C. S. FORSYTH, F.C.A.

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CONTENTS

APPROACH TO BOOK-KEEPING

THIS WORK has been written as a practical handbook for those who are concerned with the keeping of business accounts. The principal requisite of such accounts is that they should contain a full and accurate record of all the transactions of the business. It is for this reason that the first seven chapters have been devoted to a detailed consideration of the principles of double-entry book-keeping. Without a thorough knowledge of these principles any further advance in the subject is unlikely to be rewarding.

The authors do not favour the practice which has grown up in recent years of trying to teach the principles of Profit and Loss Accounts and Balance Sheets before considering the detailed records from which they spring. The ability to prepare such "final accounts" is one of the advantages that follow the use of double-entry book-keeping but it is not the main purpose for which books of accounts are kept.

It is true that in practice the professional accountant will often be told by a trader that accounts are required only for the purpose of satisfying the demands of the Inland Revenue. This is a most unsatisfactory, and at times dangerous, approach to the subject. Accounts prepared from any set of books not soundly based on the principles of double entry are bound to depend, in some degree, upon the personal estimations and recollections of the trader and little confidence can be felt in them.

In view of the rapid growth of the limited company system and the important and far-reaching provisions of the Companies Act, 1948, in regard to the accounts of such companies, considerable attention has been paid to this subject. Complicated as these provisions are, they apply to the smallest company as well as to the largest, and considerable responsibility is placed upon directors to ensure that they are complied with.

The last nine chapters of the book are devoted to certain specialized aspects of book-keeping and include the elements of cost accounts, the principles of machine accounting and the subject of insolvency.

In the hope that this work will be useful as a text-book for some of the recognized examinations in book-keeping and accountancy, a representative selection of questions drawn from recent examination papers has been added to each chapter. Some of these problems have also been used as examples in the text. In a few cases minor alterations in the questions have been made in order to bring the phraseology into line with modern practice. For permission to use these questions in this way the authors' thanks are due to the Royal Society of Arts, the London Chamber of Commerce, the Institute of Book-keepers, the Institute of Bankers, the Chartered Institute of Secretaries, the Institute of Chartered Accountants, the Society of Incorporated Accountants and Auditors, and the Association of Certified and Corporate Accountants.

CHAPTER I

GENERAL PRINCIPLES OF BOOK-KEEPING

BOOK-KEEPING is the art of recording in books of account the monetary aspect of commercial or financial transactions.

In modern practice the term book may have to be extended to certain loose-leaf and mechanical devices which serve the same function as a bound book. It is not essential that all the records of any one business or undertaking should be found in a single book; clearly that would be impossible in the case of a large concern and it would not necessarily be desirable in other cases. All the books which together contain the record of one business for a given period are known as a set of books.

Book-keeping in the strict sense does not concern itself with anything that has not a monetary value or aspect. Subject to this limitation, a set of books should record all the financial transactions of the concern; this usually involves dealing with a large variety of matters. Clearly it would be a waste of time and energy to make such a record if it did not serve any useful purpose. The entries in the books must therefore be arranged in such a way that the greatest use can be made of them.

NATURE OF RECORDS

The nature of the records to be kept will depend on two main factors:

(1) *The nature of the business carried on.* This may be commercial, professional or financial. Commercial enterprise includes the sale of goods by wholesale or by retail, the manufacture or processing of goods and the supply of services (for example, transport, electricity and gas). Banking and insurance afford prominent examples of financial institutions in which it may truly be said that book-keeping is of the very essence of the undertaking. Members of professions will also feel the need of proper records of their professional income and expenditure; in one case at least, that of solicitors, the keeping of books is prescribed by law.

(2) *The legal constitution of the undertaking.* It may be owned by a sole trader or by several traders in partnership (see Chapter VIII) or by an incorporated body such as a limited liability company (see Chapter XI), to name only the three most common forms of business association. There are also industrial and provident societies (co-operative societies), friendly societies, building societies and many other special forms of association designed for particular purposes.

With a few exceptions (for example, nationalized industries), every one of the thousands of different trades and undertakings falling under (1) can be carried on with any one of the many forms of ownership considered under (2); the resulting number of combinations defies calculation,

for new fields of commercial activity spring up almost daily. It is therefore fortunate for the student of book-keeping, and for those who have to keep sets of books, that certain fundamental principles are of universal application and, once mastered, can be applied without any great difficulty to any practical accountancy problem.

These principles, however, can be studied best by applying them to a given set of circumstances. Book-keeping as a practical subject can be learned only by working examples. These examples constitute a miniature set of books or illustrate some portion of the books that would actually be kept in practice.

It is for this reason that the first seven chapters of this work are devoted exclusively to the books of a sole trader who carries on a merchanting business involving the purchase of goods on credit (that is, not for an immediate cash settlement), and their resale to his own customers (who will probably be retail shop-keepers), also on credit. Such a trader will require his books, among other things, to show at any time how much each customer owes him.

This record will be required not only for the purpose of sending out periodical statements to the customer showing how much he owes, but also for the purpose of enforcing payment should it be necessary to invoke the process of law for that purpose. All business transactions have a legal aspect; a fact which the student of book-keeping should bear constantly in mind when approaching the more advanced stages of his studies.

The record of how much is due from a given customer will be kept most conveniently by bringing together on one page or series of pages all the transactions with that customer. Such a record which deals with one particular aspect of a trader's business affairs (in this case his transactions with a named customer) is known as an account.

Book-keeping, therefore, consists essentially of maintaining a series of accounts recording all the activities of the business. For this reason the books used are frequently known as Books of Account, and the process of book-keeping is sometimes termed Accountancy.

ADVANTAGES OF BOOK-KEEPING

Although the primary purpose of book-keeping is the keeping of a detailed day-to-day record of all transactions, many other advantages arise from such a record. The more important of these are as follows:

(1) All the assets owned by the trader and used in his business will be recorded. The term assets comprises all tangible property and equipment, such as premises (if owned), plant and machinery, stock-in-trade, debts due to the trader, cash at the bank or in hand and, as will be seen later, certain intangible but enduring values such as goodwill of the business. His liabilities to other persons will also be recorded, and by subtracting the total of his liabilities from the total of his assets on a given date the amount of his capital can be found.

(2) The increase in a trader's capital from one date to another, after allowing for any additional capital introduced from private sources

or withdrawn for personal expenditure, will represent the profit earned by the business during the intervening period. A properly kept set of books will not only enable the profit to be calculated in this rather arbitrary way, but will also show how it has arisen from the sale of goods at a price in excess of that paid for them (known as gross profit) and after payment of all expenses, such as rent, rates and salaries, incurred in carrying on the business.

(3) Accurate records of profits earned will facilitate the agreement and correct assessment of national taxation such as income tax.

(4) Should trade be bad and the trader become insolvent (that is, unable to meet his debts as they become due), the fact that proper books of account have not been kept may be held to constitute an offence if bankruptcy proceedings are instituted against him. Apart from this the keeping of proper books of account should materially help the trader to avoid getting into this unfortunate state.

(5) A trader wishing to sell his business can usually obtain a better price for it if he can produce complete and accurate accounts. A person seeking to buy a business, on the other hand, will be well advised to require the production of properly kept accounts to enable him to form an idea of the value of the business.

(6) A properly kept set of books is a considerable safeguard against the dishonesty or carelessness of employees who may be entrusted with the handling of goods or money in the ordinary course of their duties. This is particularly important where the proprietor of the business is not able to exercise personal control; as, for example, where he opens a branch in another town and places a manager in charge of it.

(7) Where the proprietors of a business (for example, the shareholders in a limited liability company) are not able to exercise any personal supervision over the business or to take any part in it other than by attending a meeting once a year, the keeping of accounts is essential so that those who are in daily control (such as directors and managers) can render a proper account of their stewardship to those entitled to receive it.

Important as all the foregoing advantages are, however, it must be stressed that they are merely advantages which follow from the keeping of a proper set of books. The real purpose of book-keeping and the main aim of the book-keeper is to maintain a full and complete record of the day-to-day transactions of the business in order that the financial state of the enterprise can be accurately ascertained.

THE LEDGER

A book or mechanical device designed to accommodate a trader's accounts is known as a Ledger. Other (subsidiary) books may, and generally will, be kept, but in the ledger is found the final and permanent record of all the transactions. It is also the source to which reference will normally be made when the trader requires such information as the amount owing by one of his customers. The ledger accounts must therefore be arranged in such a way that the information likely to be required

is most readily available. The form and functions of the ledger will be considered in detail in Chapter III, but certain fundamental principles must be noted at this stage.

The form of an account must be such that it records not only the amount of a given transaction but also its effect or direction. Thus, if a trader sells goods to A to the value of £100, the immediate effect is that the sum of £100 is owing to him by A. The account for A opened in the trader's ledger must record that fact. If A pays £60 on account of the £100, the effect or direction of this transaction is opposite to that of the first. Further, the effect of the two transactions taken together is that A owes the trader only £40. There is said to be a balance of £40 due from A. The ledger account in recording the receipt of the £60 must not only show that it is opposite in effect to the original entry of £100; it must also show that the balance now due from A is only £40, or at least must enable that fact to be ascertained in the easiest possible way.

The correct recording of the direction of a transaction is so important that the first requirement of a ledger account is that it should be divided into two sides. Thus the simple example used above could be recorded in the following way.

A's Account

	£		£
Goods sold to A on April 15	100	Cash received from A on April 20	60

The balance of £40 still due from A is ascertained by the simple process of subtracting the smaller figure £60 from the larger figure £100. If it is desired to make a permanent record of this balance, however, it could be written into the account, which would then be said to have been balanced.

A's Account

		£			£
Goods sold to A on April 15		100	Cash received from A on April 20		60
			Balance due from A on April 30	c/d	40
		100			100
Balance due from A on May 1	b/d	40			

The expressions c/d and b/d mean carried down and brought down respectively. When it is necessary to carry a balance from one page to the next the expressions c/f (carried forward) and b/f (brought forward) are used.

Account books are usually balanced at the close of business on a

given date; accounts showing the indebtedness of customers are usually balanced monthly to facilitate the rendering of statements to the customers. It will be noticed that the first entry for the balancing figure is entered as on the last day of April, whereas the balance brought down is described as on May 1. In a properly ruled ledger, separate columns will be provided for the dates. A's Account would then appear as follows:

A's Account

19—		£	19—		£
Apr. 15	Goods sold to A	100	Apr. 20	Cash received from A	60
			30	Balance due from A c/d	40
		100			100
May 1	Balance due from A b/d	40			

Further improvements in the form of the ledger account and possible variations of it will be considered in Chapter III.

The account so far considered records only the *personal* aspect of the transactions entered into by A and B; it will be seen later that a complete system of book-keeping will also record the impersonal aspect of the transactions.

DEBIT AND CREDIT

As the direction of a transaction is so important and a ledger account has to be a two-sided record, the respective sides must be capable of identification. It would be insufficient to refer merely to the left-hand or right-hand of the account. In some of the subsidiary books of account, and in certain alternative rulings of the ledger, the pages are not divided in this way. Just as a navigator, to avoid ambiguity, uses the expressior port and starboard, so the book-keeper uses two technical expressio debit and credit.

When an account is divided into two sides, the debit side is alway left-hand side, while the right-hand is known as credit. When the were sold to A in the foregoing example, the book-keeper made entry for £100 because A received the goods; in doing this he said to debit A. As a result of this entry (or rather, as a resu transaction of which this entry is the record) there is a debt du he is said to be a debtor for £100.

When A paid the £60, the book-keeper credited A's accou amount. A is still a debtor, but now only for £40; this is re balance, which is said to be a debit balance, carried down o

A debit balance arises where, before inserting any ledger account, the total of the debit side exceeds the to side. In the process of balancing (that is, making the t total), the amount £40 had to be entered first on the then brought down on the debit side, where it consti

for the next month. In short, a debit balance is one which is carried down to the debit side of the account. Conversely, a credit balance is one which is carried down to the credit side of the account.

At one time it was customary to head the two sides of a ledger account Debit and Credit (or Dr. and Cr. for short) respectively, which had the effect of emphasizing the opposite nature of the two columns of figures. It was also customary to prefix the wording on the debit side with the word *To*, while that on the credit side started with *By*. These prefixes should be indicated where ledger accounts are handwritten, if for no other reason than that they help to remind the book-keeper that the side on which an entry is made is at least as important as the amount itself. Indeed, an entry on the wrong side of an account is worse than no entry at all.

It will be noted that when A received the benefit of the transaction (that is, when he received goods from B) his account was *debited*; when A gave the benefit (that is, when he paid cash to B) his account was *credited*. The application of this principle can now be considered in relation to an account with one of B's suppliers.

Example

A trader bought goods from Z to the value of £80 on April 12, paid for them on April 21, and then bought further goods to the value of £50 on April 24. Z's account in the trader's ledger, balanced on April 30, will appear as follows:

Z's Account

19—			£	19—			£
Apr. 21	To Cash (paid to Z)		80	Apr. 12	By Goods (bought from Z)		80
30	Balance (due to Z)	c/d	50	24	”		50
			130				130
				19— May 1	By Balance (due to Z)	b/d	50

(The words in parentheses are added for explanation of the entries in this example and would not appear in a ledger account written up in actual fact.)

April 12, when the first lot of goods was bought from Z, the £80 was owing to him; he became a creditor for that amount.
Balance d money to a creditor is clearly the reverse of being owed money
May 1 r, so it was necessary to make the first entry (By Goods £80)
it side of the account. The final balance is a credit balance,
The expressio ll owing to Z; it is entered first on the debit side to make
respectively. Whe agree but is then carried down to the credit side.
the next the expre
are used. clarity, the examples so far considered have dealt only
Account books a trader's activities that concerns personal indebtedness,

either of one of his customers to him, as in A's Account, or of the trader to one of his suppliers, as in Z's Account. On further consideration it will be found that only one aspect out of two has been considered, in each case.

Thus, when he bought the goods from Z on April 12, he incurred a liability of £80, which Z's account recorded. In exchange, however, he received goods which he hopes, in due course, to sell at a profit. Until they are sold the goods are at his disposal, probably in his warehouse. They have become part of his stock-in-trade and are said to be one of his assets.

Goods will be bought, in the ordinary course of business, from many different suppliers, and each purchase will be recorded by a credit entry in the account of the supplier concerned. These entries will be spread out over a number of different accounts and their function is to record the amounts owing to the suppliers. There is not, as yet, a record in one account of the asset, stock-in-trade, created by all these purchases. In a complete system of book-keeping such a record is essential; it might appear in an account called Goods Account and the purchases from Z would give rise to the following entries:

GOODS ACCOUNT

19— Apr. 12	To (Goods bought from) Z		£ 80				
24	,,		50				

The entries are made on the debit side of the account because its function is to record the acquisition of an asset, just as when in the first example earlier in this chapter the debt due from A, which is also an asset, was reflected by an entry on the debit side.

These debit entries in Goods Account counterbalance the corresponding credit entries "By Goods (bought from Z)" in Z's account. The words in parentheses can in fact be dropped, for a debit entry in Goods Account "To Z" and a credit entry "By Goods" in Z's Account can only refer to a purchase of goods from Z. The two entries are complementary to each other and are necessary to preserve a complete record. In other words, the two-fold aspect of the transaction—the acquisition of an asset, goods or stock, in exchange for a liability incurred to Z—has been fully recorded by making a double entry in the trader's ledger. Further, in this instance a debit entry has indicated the acquisition of an asset, while a credit entry records the existence of a liability.

In the case of the sale of goods to A it cannot be said that the acquisition of an asset (the debt due from A) was balanced by incurring a liability. The debt (asset) arose because the trader sold goods to A; that is, he exchanged one asset for another. This transaction also had an effect on the trader's stock of merchandise, and since the acquisition of that stock was recorded in Goods Account the sale of part of it might also

be recorded thus, the account being renamed Trading in Goods Account or, for short:

TRADING ACCOUNT

19— Apr. 12	To Z		£ 80	19— Apr. 15	By A		£ 100
24	„		50				

It does not follow, however, that this is the best or only method of recording the sale to A. Every account in a ledger is supposed to fulfil a useful function; the balance on an account at any time should express some significant feature of the trader's business. If the trader has no other transactions during April involving the purchase or sale of goods, Trading Account as above will show a debit balance of £30.

Does this figure represent the value of the trader's stock-in-trade? Clearly it does not, for the goods sold to A on April 15 cannot at the most have cost more than £80; they may have cost less, for it does not follow that all the goods bought from Z on April 12 were resold to A on the 15th. Therefore any residue of these goods, plus the whole of the goods purchased on April 24 (after the sale to A), must be in stock if no further sales have taken place.

GROSS PROFIT

The principles to be observed in valuing a stock of goods at the end of a trading period will be considered later; let it be assumed that the trader has on April 30 a stock which is in fact worth £55. This must be added to the £100 sale, and the total, £155, compared with the total purchases of goods, £130. It will then be seen that a *gross profit* of £25 has been made during April. Alternatively, of the goods purchased for £130, those remaining unsold are valued at £55. The cost of the goods sold was therefore £75; they were sold for £100, yielding a gross profit of £25.

How this is brought into account will also be considered at a later stage, when it will be seen that a Trading Account in practice is split into its constituent parts, which are normally Stock, Purchases and Sales. At this point it is only necessary to note that a Trading Account (or its equivalent) does in fact complete the double entry so far as purchases and sales of goods are concerned.

The only other entries in the accounts of A and Z (apart from the balance carried down at the end of the month) arose from the receipt and payment of cash. It is immaterial at this stage whether the trader keeps his money in a box in his office or in a bank; he must have a fund of cash on which he can draw to meet his obligations and into which he will pay the proceeds of his trading. All receipts and payments of money constitute a distinct class of transaction and the account in which they are recorded will naturally be called the Cash Account.

As only £60 was received from A on April 20, but £80 was paid to Z on April 21, the trader must have had a balance of cash in hand before these transactions occurred. Let it be assumed that he had a balance of

£200 in hand on April 1, and that in addition to the payment to A he paid salaries amounting to £20 on April 30. His Cash Account will record all this in the following way:

CASH ACCOUNT

19—			£	19—			£
Apr. 1	To Cash in hand		200	Apr. 21	By Z		80
20	A		60	30	Salaries		20
					Balance	c/d	160
			260				260
May 1	To Balance	b/d	160				

The debit "To A £60" and the credit "By Z £80" complete the double entry for those two transactions. The debit for £60 represented an addition to one asset, cash, received in exchange for part of another asset, the debt due from A. The credit for £80, on the other hand, represented a reduction in one asset, cash, resulting in a similar reduction of a liability, the debt due to Z.

It is becoming clear that every debit entry in a ledger account is reflected by an equal and opposite credit entry in another account (or, in the case of carrying down a balance, in the same account). The opening entry in the Cash Account, representing the cash in hand on April 1, is no exception to that rule. This cash was an asset belonging to the trader on that date. As far as is known at present it was his only asset and he had no liabilities; it was in fact the capital with which he started his business. He may be said to have invested this sum in the business and will regard it as owing by the business to himself. It will therefore be represented by a credit entry in the Capital Account:

A. TRADER—CAPITAL ACCOUNT

				19—			£
				Apr. 1	By Cash in hand		200

Perhaps it is not strictly correct to regard this credit balance as a liability, for the trader does not really owe the £200 to anyone. Looking at the matter from the point of view of the business and not that of the trader personally, it can, however, be said to be a sum that has to be accounted for. Just as when Z the supplier gave value to the trader's business by selling his goods (and therefore Z was credited), so the trader himself has given value to the business and is credited in the Capital Account. It is still possible to say, therefore, that all the balances so far created represent assets or liabilities.

The payment of salaries at the end of the month raises different considerations. For simplicity let it be assumed that there is only one employee, E, who receives the whole of the £20. It would be possible to open a

ledger account for E and to complete the double entry by debiting the £20 thereto. The resulting debit balance of £20 could not be said to represent an asset. The salary is paid to E at the end of the month, after he has fully earned it; he does not owe anything to his employer, the trader. If an account were opened for E, therefore, it would have to be credited with the £20 salary due to E before it could be debited with the £20 paid to him. It would still be necessary to complete in another account the double entry for the £20 salary.

When Z sold goods to the trader he was credited with their value and Goods Account (or Trading Account) was debited. By analogy, E has sold his services to the trader; if he is credited, Salaries Account must be debited. In fact, no useful purpose is served by opening an account for E. His salary is presumably paid regularly as soon as it becomes due, so there is no need to record a liability to him. The credit entry for £20 in the Cash Account can be balanced immediately by a debit for the same amount in Salaries Account, and the same procedure will suffice whether the payment is made to one employee or to several.

NET PROFIT

It is now Salaries Account that shows a debit balance of £20, and again that cannot be regarded as an asset. This balance clearly represents one month's total of one of the expenses incurred by the trader in carrying on his business. It was assumed that the sale of goods to A resulted in a *gross profit* of £25. The payment of the salary has left the trader with a *net profit* (that is, the profit remaining after payment of all expenses) of only £5. This could be calculated in another way by considering his assets on April 30, namely:

	£
Cash (as per Cash Account)	160
Debt due from A (as per A's Account)	40
Stock-in-Trade (at value assumed for the purpose of calculating the gross profit)	55
	255
and deducting his liability to Z (as per Z's Account)	50
	£205

The trader's surplus of assets over liabilities amounts to £205 at the end of the month, which he started with a capital of £200. He has drawn nothing out for himself, so the increase of £5 is his net profit.

In practice, during any given period there will normally be many different sales of goods which give rise to gross profit, and many expenses besides salaries will be incurred. The expenses will all give rise to debit entries in suitably named ledger accounts, and a debit balance on any such account represents not an asset but a loss or expense incurred in carrying on the business. Conversely, any miscellaneous income received,

such as bank interest, will give rise to credit entries and credit balances.

Thus a debit balance may represent either an asset or a loss or expense, and a credit balance may represent either a liability or a profit or gain, but one fundamental principle is of universal application: every transaction has a two-fold aspect and therefore requires a double entry (that is, an entry in two accounts) to record it completely.

The system of book-keeping that is considered in the following six chapters is therefore known as Double-entry Book-keeping.

QUESTIONS AND EXERCISES

(Key to answers on page 569)

(1) Define assets and liabilities and give examples of each.

(2) What are the principal advantages to be derived from keeping proper books of account?

(3) What is a ledger? What main considerations must be borne in mind in deciding the form of the ledger?

(4) What do you understand by "double-entry book-keeping"?

(5) Define debit and credit.

(6) Define capital. Why does capital appear as a liability in the ledger?

(7) Distinguish between gross and net profit.

(8) (*a*) State what is meant by (i) the assets; (ii) the liabilities; (iii) the capital, of a sole trader's business, and explain how the three are related to each other.

(*b*) How does net profit or loss affect the capital of a business?

(*c*) On January 1 the capital of G. Farrar's business is £1,058. On June 30 the position of his business is as follows:

Petty Cash £10. Cash at Bank £296 7s. 6d. Sundry Debtors £347 9s. 6d. Sundry Creditors £418 2s. 6d. Furniture and Fittings £290. Stock £588 7s. Farrar has withdrawn £400 during the half-year.

Draw up a statement to show the position of Farrar's business at June 30, and estimate his net profit for the half-year. (*L.C. of C. Elem.*).

(9) Brown and Smith are two merchants. At January 1 Smith owed Brown £146 3s. 9d., and during the month of January the following transactions took place between them:

			£	s.	d.
Jan.	5	Brown purchased goods of Smith	126	4	3
,,	12	Smith sends goods to Brown	50	1	9
,,	15	Brown pays cash to Smith	95	0	0
		Smith allows discount	5	0	0
,,	20	Smith allows Brown's claim for damaged goods	10	0	0
,,	24	Smith sells to Brown goods	131	6	8
,,	30	Brown borrows from Smith for temporary accommodation	50	0	0

You are required:

(*a*) To give the account of Brown in the ledger of Smith;
(*b*) To bring down the balance at the end of January;
(*c*) To state which party is indebted to the other.

(*Inst. of Bankers, Part I*).

CHAPTER II

THE JOURNAL

ALTHOUGH in a system of double-entry book-keeping the ledger is the essential book of account, it would not be convenient in any but the smallest of businesses to have all entries made directly into the ledger. Even in a small business, where the proprietor keeps his own books, there is much to be said for making the original or prime entry in some other book, from which the ledger can be written up or "posted" at convenient intervals. In a large business, where the work of the office has to be shared by a staff of book-keepers and others, some division of the work into prime entry and posting is essential.

Apart from the practical convenience of this preliminary record, there is also some advantage in having a chronological record, that is, a book or series of books containing all transactions in order of date. Office records such as invoices and receipts are usually filed in that order; the original entries in the books should preferably follow the same sequence. Further, if for any reason it became necessary to refer to all the transactions that occurred during a given day or period, and the ledger were the only account book kept, it might be necessary to examine many hundreds of accounts in order to locate the few in which entries occurred for that date or period.

When the theory and practice of double-entry book-keeping were first developed, businesses tended to be smaller and more personal than now. The books were kept by the trader himself or with the assistance of a confidential clerk. Because the book-keeping work did not have to be divided between several book-keepers, the best type of book of prime entry was considered to be one which recorded all the transactions that occurred. This one book contained a complete record in chronological order; the ledger contained the same information sorted into appropriate accounts. Such a book of prime entry was, in effect, a financial diary or Journal, and the latter is the name by which it is still known, although both the use and form of the journal have undergone important changes.

FORM OF THE JOURNAL

Essentially, the journal should show:

(1) Date of the transaction.

(2) Brief details of the transaction.

(3) Names of the accounts to be debited and credited respectively.

(4) Amount to be debited to the one account and credited to the other.

(5) Page or folio of each account in the ledger to which an item has been posted. This is required both for ease of reference to the ledger and to enable the book-keeper to see at a glance which items have been posted and which have not.

A typical journal is therefore ruled as follows:

Journal

Date	Particulars	Folio	Dr.	Cr.

This ruling is so universal in its use that the headings are generally discarded. If the simple transactions considered in Chapter I were entered in the journal as a preliminary to posting to the ledger, they would be recorded in the following way:

A. Trader's Journal

Date	Particulars	Folio	Dr.	Cr.
19— Apr. 1	Cash Dr. To A. Trader, Capital Account being cash in hand constituting A. Trader's capital at this date		200 0 0	200 0 0
12	Goods (or Purchases) Dr. To Z being goods purchased from Z as per his invoice		80 0 0	80 0 0
15	A Dr. To Goods (or Sales) being goods sold to A as per copy invoice		100 0 0	100 0 0
20	Cash Dr. To A being payment on account received from A		60 0 0	60 0 0
21	Z Dr. To Cash being payment to Z in settlement of his account		80 0 0	80 0 0
24	Goods (or Purchases) Dr. To Z being goods purchased from Z as per his invoice		50 0 0	50 0 0
			£570 0 0	£570 0 0

It will be observed that these journal entries conform to the rules of double entry already laid down and that:

(1) A suitable description is given to each entry. This is known as the narration and should always be given, even though the entry appears to be self-explanatory.

(2) The insertion of the abbreviation Dr. at the end of the first line of each entry serves to emphasize which of the two accounts is to be

debited and helps to guard against the postings being inadvertently reversed.

(3) The prefix To before the name of the account to be credited serves the same purpose. The literal meaning of the complete entry in the particulars column is thus (in the case of the purchase of goods from Z): Goods (or Purchases) Account is a debtor to Z for goods purchased from him.

(4) The narrow column in front of the debit cash column will have the folio reference of the appropriate ledger account entered in it immediately each item is posted to the ledger.

(5) The journal is not used in the process of carrying down the balances on the ledger accounts. The carrying down of a balance is part of the process of double entry, but as both debit and credit entries are found in the same ledger account it is unnecessary to post them from the journal.

In practice the journal is not used to record the routine transactions already illustrated; more convenient books of prime entry have been designed and are considered in Chapter IV. The journal proper (as distinct from such books as Sales and Purchases Books) is now employed only to record opening and closing entries and exceptional and non-recurring transactions for which no other book of prime entry is available. Nevertheless, the use of the journal for a complete record of all transactions has both an historical and a theoretical background. In some countries traders are still compelled by law to keep a journal (possibly in a somewhat modified form), in which all their transactions are recorded.

The journal will now be used to illustrate the two-fold nature of various other business transactions and to show how they are recorded in double-entry book-keeping.

Example (a)

On July 6, A sold goods to B to the value of £250, less trade discount 25 per cent, and subject to a cash discount of $2\frac{1}{2}$ per cent for payment within one month.

On July 10, B returned part of the goods to A as having been damaged in transit, retaining the remainder. The goods returned had originally been invoiced at £120 less 25 per cent trade discount.

On July 31, B paid the balance due from him, deducting the cash discount of $2\frac{1}{2}$ per cent.

A's Journal

(*page* 2)

19— July 6	B Dr.		SL 3	187 10 0	
	To Sales		GL 3		187 10 0
	Sale of goods as per invoice	250 0 0			
	Less trade discount 25%	62 10 0			
		£187 10 0			

July 10	Returns Inwards Dr. To B Return of part of goods invoiced on July 6 at *Less* trade discount 25%	 120 0 0 30 0 0 £90 0 0	GL 4 SL 3	90 0 0	 90 0 0
31	Cash Dr. To B Cash received from B (£97 10s. 0d. less cash discount $2\frac{1}{2}$%, £2 8s. 9d.)		CB 1 SL 3	95 1 3	 95 1 3
31	Discount allowed Dr. To B Cash discount deducted by B as above		GL 7 SL 3	2 8 9	 2 8 9

(The references in the folio column are to the ledger accounts dealt with in Chapter III).

It will be observed that, in recording the above transactions:

(1) The *trade* discount is regarded as a reduction in the invoice price of the goods. This discount is allowed to B by virtue of his trading relationship to A and does not depend on prompt payment of the account. £250 may be a fixed price at which B must ultimately sell the goods to his customers; the deduction of 25 per cent, then, represents the gross profit that will ultimately be made by B. Goods are not always sold subject to a trade discount. In this instance the same result would have been achieved (from A's point of view) if he had invoiced the goods at £187 10s. 0d. in the first place.

(2) The issue of the credit note to B in respect of the goods returned is in effect a cancellation of part of the original invoice. The goods have come back into A's warehouse, where they will probably be reconditioned and eventually sold once more. The £90 might have been debited to Sales Account, but it is better to record such credits and allowances separately. A Returns Inwards Account has therefore been used; this might alternatively have been called Sales Returns Account.

(3) No record is made in respect of the cash discount until B earns the right to make this deduction by paying the balance of his account within the month. A discount of $2\frac{1}{2}$ per cent on £97 10s. 0d. (6d. in the £) is £2 8s. 9d., so B actually pays £95 1s. 3d. in cash. Cash Account must record the amount actually received, but B must be credited altogether with £97 10s. 0d. as he has discharged his account in full. The £2 8s. 9d., therefore, has to be shown separately in the books; it is taken to debit of Discount Account (or, alternatively, Discount Allowed Account).

From A's point of view, this discount is one of the expenses incurred by him in carrying on his business. It is an inducement he offers to his customers to encourage prompt payment.

(4) The last two journal entries might very well have been combined:

19— July 31	Cash Dr. Discount To B being payment by B of his account less 2½% cash discount	CB 1 GL 7 SL 3	95 1 3 2 8 9	 97 10 0

Example (b)

On July 7, A purchased goods from Z at a cost of £127 10s. 0d., but returned them on July 11 as not being up to specification. He purchased further goods from Z on July 20 to the value of £156 10s. 0d., and paid Z therefor on July 29, deducting a cash discount of 5 per cent.

A's Journal (*page* 3)

19— July 7	Purchases Dr. To Z being purchase of goods as per invoice	GL 5 BL 3	127 10 0	 127 10 0
11	Z Dr. To Returns Outwards (or Purchases Returns) being return of goods not up to specification	BL 3 GL 6	127 10 0	 127 10 0
20	Purchases Dr. To Z being purchase of goods as per invoice	GL 5 BL 3	156 10 0	 156 10 0
29	Z Dr. To Cash Discount being payment of Z's account less cash discount 5%	BL 3 CB 1 GL 7	156 10 0	 148 13 6 7 16 6

Example (c)

On July 12, A purchased a new weighing machine from X Ltd. for £85, and paid for it on July 31.

A's Journal (*page* 4)

19— July 12	Plant Dr. To X Ltd. being purchase of weighing machine, No. AB12345, from X Ltd.	GL 1 BL 4	85 0 0	 85 0 0
31	X Ltd. Dr. To Cash being payment of X Ltd. account	BL 4 CB 1	85 0 0	 85 0 0

It will be observed:

(1) That as A purchased the machine for use in his business and not for the purpose of selling it to someone else in the ordinary course of business, the first debit is made to Plant Account and not to Purchases Account. Had A been a dealer in weighing machines and bought this machine for resale he would, of course, have treated the transaction as an ordinary purchase.

(2) The goods purchased from Z in the previous example (until they are resold) and the weighing machine are both assets belonging to A's business. They are, however, fundamentally different kinds of asset, since the one is intended to be resold in the same condition whereas the other is intended to be used. This distinction is very important and is considered more fully at a later stage.

(3) By making two entries at different dates:

(*a*) The asset is brought into the books on the date of its acquisition, when the business first receives the benefit of it, and at the same time the liability to X Ltd. is recorded.

(*b*) The discharge of the liability to X Ltd. at a later date is subsequently recorded.

Had the machine been bought and paid for on the same day no useful purpose would have been served by opening a personal account for X Ltd. Indeed, A might have attended an auction sale and purchased the machine for cash. If it is not desired to record the personal aspect of the transaction one entry will suffice:

19— July 12	Plant Dr. To Cash being purchase of weighing machine —Makers X Ltd., No. AB12345	GL 1 CB 1	85 0 0	 85 0 0

Example (*d*)

On July 31, A paid the following amounts:

Salaries for month ended July 31	£25	0s.	0d.
Electricity for quarter ended June 30	£12	10s.	3d.
Fire Insurance for year commencing June 24	£6	5s.	0d.
Stationery	£6	2s.	3d.

A's JOURNAL (*page* 5)

19— July 31	Salaries Dr. To Cash being wages for month ended July 31	GL 8 CB 1	25 0 0	 25 0 0
31	Lighting and Heating Dr. To Cash being electricity a/c for qtr. ended June 30	GL 9 CB 1	12 10 3	 12 10 3

July 31	Insurance Dr. To Cash being fire insurance premium, XYZ Insurance Co. Ltd. Policy No. 87654 for year commencing June 24	GL 10 CB 1	6 5 0	 6 5 0
31	Stationery Dr. To Cash being stationery purchased from S & Co.	GL 11 CB 1	6 2 3	 6 2 3

All the above payments are in respect of expenses incurred in carrying on A's business. The first three relate to distinct periods of time—a week, a quarter and a year. The fourth results in the acquisition of stationery which will be used over some indefinite future period. With the possible exception of the stationery, it cannot be said that any of these payments results in the acquisition of an asset. In each case cash is paid out and Cash Account has to be credited; the debit entry is made in a ledger account which shows the nature of the expenditure incurred.

Example (*e*)

A has been in business for some time, but prior to July 1 he did not keep a full set of books. Double-entry book-keeping is to be commenced as from that date, on which it is ascertained that A's capital was £880 2s. 6d. He had the following assets:

	£	s.	d.
Plant	250	0	0
Stock	436	0	0
Sundry Debtors (that is, debit balances due from customers): C £94 3s. 6d., D £18 2s. 1d.	112	5	7
Cash	209	3	2
He owed the following amounts to Sundry Creditors (that is, credit balances due to his suppliers): M £81 2s. 6d., N £46 3s. 9d.	127	6	3

A's Journal (*page* 1)

19— July 1	Plant Dr.	GL 1	250 0 0	
	Stock	GL 2	436 0 0	
	C	SL 1	94 3 6	
	D	SL 2	18 2 1	
	Cash	CB 1	209 3 2	
	To M	BL 1		81 2 6
	N	BL 2		46 3 9
	A, Capital Account	GL 13		880 2 6
	being A's assets and liabilities on this date and resulting balance of his capital		£1007 8 9	£1007 8 9

This is another composite entry, and as it is not immediately obvious that the debits balance the credits, totals are entered. The £880 2s. 6d. credited to A's Capital Account makes the two sides of the entry balance, because it was, in fact, the excess of his assets over his liabilities.

Example (*f*)

On July 31, A learned that D had filed his petition in bankruptcy and it was unlikely that any dividend would be received from D's estate. It was therefore decided to write off the balance due from D.

A's JOURNAL (*page* 6)

19— July 31	Bad Debts To D being bad debt arising from D's bankruptcy	GL 12 SL 2	18 2 1	 18 2 1

The writing off was necessary because the £18 2s. 1d. standing to the debit of D's account no longer represented an asset; it was valueless. Most traders who have to give credit incur such bad debts from time to time; amounts written off to Bad Debts Account therefore represent an additional expense incurred in carrying on the business.

Example (*g*)

On September 1, R agreed to purchase for £5,000 the business carried on by S up to that date. S agreed to transfer to R assets which were valued as follows: Fixtures and Fittings, £500; Plant, £1,000; Stock-in-Trade, £2,000.

It was agreed that S should collect the book debts due to him and should pay all outstanding creditors. On September 1, R opened a new banking account for the purpose of the business and paid in £7,000 from his own account. On September 2 he paid S the £5,000 due to him under the vending agreement.

The purchase price exceeds the value of the tangible assets acquired by R by £1,500. This amount is paid by R for the benefit of taking over S's business as a going concern and for the right to hold himself out as a successor to S and to continue to trade with the latter's customers. This value, which normally attaches to any successful business, is known as *goodwill*.

The opening journal entries will be as follows:

R's JOURNAL

19— Sept. 1	Cash Dr. To R. Capital being capital introduced by R		7,000 0 0	 7,000 0 0

Sept. 1	Goodwill Dr.		1,500 0 0	
	Fixtures and Fittings		500 0 0	
	Plant		1,000 0 0	
	Stock		2,000 0 0	
	To S			5,000 0 0
	being assets acquired from S and consideration therefor, per vending agreement			
— 2	S Dr.		5,000 0 0	
	To Cash			5,000 0 0
	being discharge of purchase consideration			

QUESTIONS AND EXERCISES

(Key to answers on page 569)

(1) Give entries in the journal proper to record the following in the books of T. Benson, a baker:

(*a*) The correction, on March 1, of £28 expended on advertising previously charged in error to Repairs Account.

(*b*) T. Benson received a horse and van worth £125 from R. Dickson on March 3 in part payment of a debt.

(*c*) T. Benson heard on March 5 that £5 6s. 8d. cash discount which he had deducted when paying an amount due to F. Williams was not allowable.

(*d*) On March 8 T. Benson bought a new gas oven from B. Thomas, on credit, at a cost of £210. (*R.S.A. Stage I*).

(2) By means of journal entries show how you would record the following:

May 31 Received a letter from A. Archer stating that he cannot allow the £5 cash discount you had deducted when paying his account.

June 4 The correction of £28 cash purchases debited in error to Wages Account.

,, 10 Goods for resale worth, at cost, £63, and shop fittings valued at £37, received in settlement of £100 owing to you by B. Good.

,, 30 Write 5 per cent depreciation off machinery at present standing in your ledger at £2,100. (*R.S.A. Stage I*).

(3) Show, by means of journal entries, how the following transactions of Richards, a house builder, should be dealt with in his books:

Apr. 5 B. Richards received a credit note for £28 from Timber Suppliers, Ltd., for timber short delivered.

,, 7 B. Richards bought a motor lorry for £500 from C. Ford, who took his old lorry and allowed him £200 for it. B. Richards paid the balance in cash.

,, 30 B. Richards wrote 5 per cent depreciation off his Plant and Machinery standing in his books at £2,500. (*R.S.A. Stage I*).

(4) A. Trader commenced business on October 1, 1948, with Cash £500. At the end of his first year of trading his position was as follows: Balance at Bank £125, Cash in Hand £27, Stock £462 and Debtors £107. Also he owed Creditors £45 and had borrowed £250 which had not been repaid.

During the year, A. Trader had drawn £6 per week, had paid his private life assurance premium of £10 out of the business banking account and had taken goods for private use to the value of £52.

Prepare (*a*) statement showing the net profit for the year ended September 30, 1949, and (*b*) the entry in the journal required to open proper books of account at that date. (*R.S.A. Stage II*).

(5) Give journal entries to record the following transactions in the books of J. Johnson:

(*a*) Bought from Equipment Co. a new show-case value £19 10s. 0d.
(*b*) Goods taken from stock for use in private house, £5 10s. 0d.
(*c*) Depreciation to be charged on Plant and Machinery at $7\frac{1}{2}$ per cent. (The ledger balance of Plant and Machinery Account is £1,250.)
(*d*) A purchase from J. Field value £37 was posted to the credit of J. Mills.

(*L.C. of C. Elem.*).

(6) State precisely the meaning of each of the entries in the following account which appears in R. Ledward's ledger:

J. FROST

19—			19—		
Jan. 10	To Sales	80 0 0	Feb. 5	By Cash	76 0 0
				Discount	4 0 0
		£80 0 0			£80 0 0
June 6	To Sales	60 0 0	June 17	By Returns	10 0 0
			Dec. 30	Cash	12 10 0
			30	Bad Debt	37 10 0
		£60 0 0			£60 0 0

(*L.C. of C. Elem.*).

(7) A trading business, X & Co., employs a debt-collecting agency, Catchem & Co., to collect doubtful debts. Catchem & Co.'s charges for these services are recovered wherever possible from the debtors concerned and the debtors' individual balances are always left standing on their original accounts until recovered or considered definitely bad. Catchem & Co. render statements monthly.

At the beginning of March the following accounts were in the hands of Catchem & Co. for collection: A. Brown, £15 17s. 6d.; C. Davids, £8 5s. 0d.; E. Foster, £23 10s. 0d.; G. Horwood, £12 5s. 9d.; T. Jones, £7 12s. 0d.

On April 10, X & Co. received from Catchem & Co. a cheque for £20 5s. 6d., together with a statement giving the following details:

	£ s. d.	£ s. d.
Amounts collected during March:		
Brown, on account	5 0 0	
Foster	10 0 0	
Jones, balance and charges	8 13 0	
		23 13 0
Less charges:		
re Brown	15 0	
Foster	1 1 0	
Horwood	10 6	
Jones	1 1 0	
		3 7 6
		£20 5 6

At the same time, Catchem & Co. notified X & Co. that they considered the remaining balances due from Brown and Horwood to be irrecoverable and the other balances to be good.

X & Co. credited the cheque to a personal account in the name of Catchem & Co.

Set out in the form of journal entries the adjustments which are required in the books of X & Co. Ledger accounts are not required. (*R.S.A. Stage III*).

CHAPTER III

THE LEDGER

THE general nature of a ledger account has been considered in Chapter I. A ledger account should show clearly and without ambiguity:

(1) Its name.

(2) Its page number or some other reference, so that the ledger can be indexed and posting references inserted in the books of prime entry.

(3) In respect of each transaction entered or posted in the account:

(*a*) Its date.

(*b*) A sufficient description to show its nature.

(*c*) A posting reference to show the page or folio in the book of prime entry from which it has been posted.

(*d*) The amount (that is, monetary value) of the transaction.

(*e*) Whether it is a debit or a credit entry.

(4) The distinction between debit and credit entries. These must be so arranged as to enable the balance of the account to be ascertained at any time and, if desired, entered in the account and carried forward to a further section thereof.

CLASSIFICATION OF ACCOUNTS AND LEDGERS

To determine the best form of a ledger account and the best arrangement of the accounts in a ledger it is necessary to consider the purpose intended to be served by the various accounts. It has been seen that, in addition to recording indebtedness to and from other persons, the ledger has to contain a record of transactions of various types. It has already been explained that an account which records personal indebtedness is known as a personal account and that all other ledger accounts are impersonal accounts. Except in the smallest concerns several ledgers are necessary to accommodate the large number of accounts that must be maintained. The classification of accounts according to their nature affords a ready means of separating them into different ledgers.

Personal accounts fall into two contrasting groups, dealing with customers and suppliers respectively:

(1) Accounts of customers (that is, persons to whom goods are sold) are kept in a Sales Ledger and are known as Sales Ledger accounts.

(2) Accounts of suppliers (that is, persons from whom goods are bought) are kept in a Bought Ledger and known as Bought Ledger accounts.

Impersonal accounts also fall into two groups:

(1) Accounts which record the acquisition and subsequent changes in an asset, such as cash, stock, plant or goodwill, are known as Real Accounts.

(2) Accounts which record income and expenditure, such as rent or salaries, are known as Nominal Accounts.

When all real and nominal accounts (except cash) are found in the same ledger it is known as a General or Impersonal Ledger. It is sometimes

found that the expression Nominal Ledger is applied in such a case, but more properly that title should be reserved for a ledger which contains nominal accounts only. The real accounts will then be found in a separate ledger which is usually called a Private Ledger. This will contain, in addition to the detailed records of assets, an account recording such confidential information as the proprietor's capital, profits and drawings. A private ledger is sometimes provided with a device which enables it to be locked when not in use.

The strict division of accounts into real and nominal does not always serve the best interests of the business. Some of the nominal accounts may be of a private and confidential character (for example, Salaries) which makes it desirable that they should be kept in the Private Ledger. Some of the real accounts (for example, Plant) may, on the other hand, be in frequent demand for the information which they contain and can conveniently be kept outside the Private Ledger. In such a case the ledger which contains all the real and nominal accounts other than those that are private should be called the General Ledger.

NAMING OF PERSONAL ACCOUNTS

The name of a personal account is that of the customer or supplier whose transactions with the business are to be recorded therein. In the business world the names of persons cover a variety of forms of commercial association of which, in addition to individuals (sole traders), the most important are partnerships and limited companies. If care is taken, as it should be, to enter the name accurately, the type of business association will be indicated clearly. Thus

W. Smith.
Smith & Co.
W. Smith, Ltd.

indicate respectively an individual, a partnership (in which the present partners may in fact be Brown and Robinson) and a limited company which, regardless of the number of shareholders, is legally a separate "person." If the business of "W. Smith," however, is known to be carried on by H. Brown, the full title of the account will be "H. Brown trading ... Smith" (often abbreviated to "H. Brown t/a W. Smith").

... addition to the name, the current address of the customer or supplier ...requently recorded at the head of the account, as this facilitates the ...ndering of statements and tends to avoid confusion between two accounts ...ith similar names. The terms of credit allowed to customers or by suppliers may also usefully be noted, particularly where special terms apply to some accounts.

When an account extends over several consecutive pages in the ledger, the name at least should be entered on each page.

NAMING OF IMPERSONAL ACCOUNTS

The name of an impersonal account should be such as to describe, as accurately and yet as concisely as possible, the type of transaction which it is intended to record. It has been seen that the function of a nominal

account is to record expenses incurred in carrying on a business and profits accruing to it. Now in the course of a year, expenditure (much of it comparatively small in amount) will be incurred that could be recorded under hundreds of different headings. It would be possible, for example, to open an account to record the cost of office teas, but little practical advantage would follow from doing so. When, therefore, all the more important items of expenditure, such as salaries, rent, printing and stationery, lighting and heating, and insurance, have been separately recorded in their respective accounts a General Expenses Account will cover all miscellaneous items of expenditure.

The degree of classification and analysis required will depend on the size and nature of the business. Thus, in most cases it is sufficient to record all types of insurance in one Insurance Account; in others it may be desirable to maintain separate accounts for Employers' Liability, Public Liability, Fire and General Insurances. The amount of subdivision necessary is also controlled to a certain extent by the form of the Profit and Loss Account, or other annual account of income and expenditure, in which all the expense and income accounts are combined to show the trading result of the year. This factor is considered in detail in Chapter V.

At this stage it may be said that it is better to err on the side of too much analysis than too little. The book-keeper who is in doubt as to the number of accounts to open in the Nominal Ledger should therefore open as many as is reasonably possible. If at a later date it is found that less separation of expenditure is required, two or more accounts can quite easily be transferred into one, whereas if the reverse process is called for it will be necessary to re-examine every item in the existing account in order to analyse it under the additional headings.

LOOSE-LEAF LEDGERS

However carefully a bound ledger is arranged it tends to become unwieldy when the number of accounts exceeds a few hundred. Where thousands of accounts are involved no one ledger can possibly contain them. A series of bound ledgers in which the accounts are subdivided may contain all the accounts required but this method is open to the fol[illegible] objections:

(1) The bound ledgers are either very large and bulky, and therefore difficult to use, or, alternatively, they tend to become filled up much too quickly.

(2) The opening of new ledgers when the old ones have been filled involves the transfer of all the balances and the reheading and indexing of all the accounts.

(3) Over the course of a few years one account may be recorded successively in three or four different ledgers. To trace an account back over a period of years, as is sometimes necessary, becomes an extremely laborious business.

(4) Some of the accounts may no longer be required but they remain in the current ledgers until new ones are opened.

(5) Only one clerk can work on one ledger at one time.

LOOSE-LEAF METHOD

All these difficulties and objections can be overcome by the use of loose-leaf ledgers.

It must be admitted that loose-leaf records possess certain disadvantages, of which the greatest is the risk that sheets containing essential records may be extracted and mislaid, but if proper precautions are taken these disadvantages can be minimized. The advantages are so obvious and, in the case of personal accounts, so outweigh the disadvantages that the use of loose-leaf personal ledgers has become the rule rather than the exception in all but the smallest concerns.

PAGE OR FOLIO NUMBERS

A bound ledger is usually provided with printed page numbers. When both sides of an account are entered on the same page of the book, it is said to be paged. Sometimes, however, the record is spread over the two pages that appear at one opening of the book. These two pages are then numbered alike and the number is known as a folio.

Loose-leaf or card ledgers cannot, as a rule, have their pages numbered in sequence, as that would defeat their principal advantage (the ability to insert additional sheets at any point in the ledger). Some numerical reference should be given to each page, however, so that proper posting references can be made in the books of prime entry. The simplest method is to number consecutively in each section of the ledger each new account that is opened and to give a second consecutive number to the successive pages of that account, when it extends to more than one page. Thus, if the account of W. Smith is the tenth account to be opened in the S section of the ledger, the page reference S 10/3 would indicate the third page of Smith's account, which is the tenth account in the S section.

INDEXING A BOUND LEDGER

In a bound ledger an index is essential for easy reference to individual accounts. A loose-leaf ledger is usually so arranged that direct reference to accounts is possible; an index should still be kept, however, as it affords the only complete record of the names of all accounts opened and therefore guards against the loss of sheets which have been temporarily removed from their binder.

The index to a bound ledger is usually found at the front and may deal with one or two letters at an opening.

When a new ledger is opened care should be taken to space out the accounts so that the successive pages of a large account will fall as far as possible together. In an Impersonal Ledger it is usually possible to gauge fairly closely the probable requirements of each account for a given period of years.

Where personal accounts are concerned, however, the accurate spacing of the ledger is an ideal rarely to be attained except at the cost of wasting a large number of pages. An account that is expected to be small may grow unexpectedly; a large account may decline. When the number of pages originally allocated to an account has been exhausted it will therefore be necessary to reopen it at another convenient page. In such a case the original page or folio number should be crossed through in the index and

the new one inserted next to it. Care should be taken not to obliterate completely the original numbers as they may be required to trace an account through the ledger. The old and new pages in the ledger should also be cross-referenced to each other.

INDEXING A LOOSE-LEAF LEDGER

Loose-leaf ledger binders are usually supplied with index pages for each letter of the alphabet. The projecting tabs of the index then divide the ledger into its component sections and thus facilitate direct reference to the accounts.

If each account has been given a reference as already indicated, these should be entered on the index sheets. In a large ledger there may be several hundred accounts indexed under each of certain letters such as B and S. Unless such an index is arranged methodically it will tend to become too unwieldy for easy reference and may fall into disuse. This tendency may be minimized by use of the vowel indexing system and most manufacturers of loose-leaf ledgers supply indexes ruled accordingly. In such indexes the space allotted to each letter of the alphabet is divided into subsections, and each account is entered in the appropriate subsection according to the first vowel which occurs in its name.

The numbers are given to the accounts in the order in which they happen to be opened and will remain unaltered during the currency of the ledger. As the chief purpose of the numbers is to provide a posting reference, the sheets need not be entered in the binder in this numerical order; strict alphabetical order will facilitate direct reference to the ledger and is to be recommended if there are several hundred accounts.

SUB-DIVISION OF PERSONAL LEDGERS

When the number of customers is so great that the accounts cannot all be contained in one Sales Ledger (that is, a single bound book or loose-leaf binder) some further subdivision is necessary. This can be alphabetical, for example:

Sales Ledger	A—G
,,	H—N
,,	O—S
,,	T—Z

or it can be geographical, for example:

Sales Ledger	London
,,	Home Counties
,,	North Midlands

Except when the subdivision is alphabetical by reference to the names of the accounts, it is desirable that one index should be maintained for all the ledgers; this can conveniently take the form of an alphabetical card index.

Other classifications are possible, but care should be taken to avoid a duplication of accounts. For example, if the business is divided into several distinct departments for some purposes it might be convenient

to keep one Sales Ledger for each department. Many customers will buy from more than one department, however, so that this system may result in one customer having several ledger accounts. This may lead to excessive credit being allowed, and difficulty will also arise when posting cash received from such customers, who may send one cheque to cover amounts recorded in two or three different ledgers. The rule "one customer—one account" is therefore an excellent one and should be borne in mind when designing the layout of a new set of ledgers.

ALTERNATIVE RULINGS OF LEDGERS

Although for most purposes the orthodox two-sided account used in the first of the following examples is generally regarded as the best, there are alternative rulings which retain all the essential features of a ledger account as already defined.

When the majority of the entries will be on one side of the account (for example, in the Sales Ledger, where there may be twenty or so debits each month, representing invoices for goods sold, against one credit only for the cash received at the monthly settlement) space can be saved by using a journal-ruled form of ledger in which the date, particulars and folio columns are common to both debit and credit entries.

The distinction between debit and credit entries in the ledger is still maintained in the money columns and the account can be balanced periodically as required.

When it is necessary to know the balance of each account at a glance (for example, as a banker requires to know the balance on each customer's account) a third column for this purpose can be added to the journal ruling.

This form of ledger account is common in machine systems of book-keeping where the throwing out of a balance after each posting (or group of postings made at the same time) is part of the normal routine and is performed automatically by the machine.

These three main alternatives are illustrated in the following examples, the same transactions being recorded in each case.

Example (*a*)

T. HARDY

19—				19—			
Jan. 2	To Balance	b/f	81 3 4	Jan. 10	By Cash	2	81 3 4
6	Goods	3	35 0 0	13	Returns	101	12 10 0
9	,,	7	12 10 0	31	Balance	c/d	178 10 6
12	,,	11	58 6 8				
16	,,	15	49 1 7				
24	,,	26	36 2 3				
			£272 3 10				£272 3 10
19—							
Feb. 1	To Balance	b/d	178 10 6				

Example (b)

T. HARDY

19—				
Jan. 2	To Balance	b/f	81 3 4	
6	Goods	3	35 0 0	
9	,,	7	12 10 0	
10	By Cash	2		81 3 4
12	To Goods	11	58 6 8	
13	By Returns	101		12 10 0
16	To Goods	15	49 1 7	
24	,,	26	36 2 3	
31	By Balance	c/d		178 10 6
			£272 3 10	£272 3 10
Feb. 1	To Balance	b/d	178 10 6	

Note. Although this method actually uses more lines to record the same entries as in (*a*), the width of the page required is much less. This is particularly convenient if a card ledger is used.

Example (c)

T. HARDY

			Dr.	Cr.	Balance
19—					
Jan. 2	To Balance	b/f	81 3 4		81 3 4
6	Goods	3	35 0 0		116 3 4
9	,,	7	12 10 0		128 13 4
10	By Cash	2		81 3 4	47 10 0
12	To Goods	11	58 6 8		105 16 8
13	By Returns	101		12 10 0	93 6 8
16	To Goods	15	49 1 7		142 8 3
24	,,	26	36 2 3		178 10 6

Note. This method has the additional advantage that the monthly balancing of the account is unnecessary, as the balance at any date is recorded. In the example the balances are all debit balances, which is to be expected in a Sales Ledger, and no special reference to that fact is necessary. Where, however, the account is such that either debit or credit balances may arise (for example, the account of a customer who has overdraft facilities, in the ledger of a bank) separate columns must be provided for debit and credit balances respectively; or, alternatively, the same column can be used with different coloured inks to indicate debit or credit balances.

A Sales Ledger account may occasionally show a credit balance (for example, if the account is overpaid in error) and in that case the balance should be entered in red ink or in some other distinctive way. Book-keeping machines automatically print such balances in red and add a special sign, such as "Cr.Bal.", after the entry. Similar steps should be taken when recording a debit balance in the Bought Ledger. Such a state of affairs will normally arise only when the trader has overpaid his supplier or has returned goods or empties after paying for them. The fact that such a balance is recorded in red ink is an additional advantage, for it draws attention to a balance due to the trader which might otherwise be overlooked.

The journal entries illustrated in Examples (*a*) to (*f*) in Chapter II will now be posted to the ledger in order to show its division into component parts, to emphasize the completion of the double-entry and to bring out some additional advantages of double-entry book-keeping which have not already been mentioned.

A's Ledgers

(*Personal Accounts*)

(1) SALES LEDGER

C — 1.

19— July 1	To Balance	J.1	94 3 6				

D — 2.

19— July 1	To Balance	J.1	18 2 1	19— July 31	By Bad Debt	J.6	18 2 1

B — 3.

19— July 6	To Goods	J.2	187 10 0	19— July 10 31	By Returns Cash Discount	J.2 J.2 J.2	90 0 0 95 1 3 2 8 9
			£187 10 0				£187 10 0

Notes. (1) It is usual to prefix the £ sign to a total; this emphasizes that the figure in question is a total and not an amount posted from another book. The prefix should never be used except in regard to a total.

(2) One posting might have been made to the credit of B's account on July 31 for "Cash and Discount £97 10 0." Alternatively, if the ledger is provided with two cash columns on each side, it could be written up as follows:

B — 3.

19— July 6	To Goods	J.2		187 10 0	19— July 10	By Returns Cash Discount	J.2 J.2 J.2	 95 1 3 2 8 9	90 0 0 97 10 0
				£187 10 0					£187 10 0

(2) Bought Ledger

M — 1.

				19— July 1	By Balance	J.1	81 2 6

N — 2.

				19— July 1	By Balance	J.1	46 3 9

Z — 3.

19— July 11	To Returns	J.3	127 10 0	19— July 7	By Goods	J.3	127 10 0
29	Cash and Discount	J.3	156 10 0	20	,,	J.3	156 10 0
			£284 0 0				£284 0 0

X Ltd. — 4.

19— July 31	To Cash	J.4	85 0 0	19— July 12	By Plant	J.4	85 0 0

(*Impersonal Accounts*)

Cash Account

(usually kept in a separate book and therefore called the Cash Book)

19— July 1	To Sundries	J.1	209 3 2	19— July 29	By Z	J.3	148 13 6
31	B	J.2	95 1 3	31	X Ltd	J.4	85 0 0
					Salaries	J.5	25 0 0
					Lighting and Heating	,,	12 10 3
					Insurance	,,	6 5 0
					Stationery	,,	6 2 3
				31	Balance	c/d	20 13 5
			£304 4 5				£304 4 5
Aug. 1	To Balance	b/d	20 13 5				

Note. Modifications in the form of the Cash Book (which, being kept as a separate book, need not be ruled in the same way as other ledger accounts) and in particular the way in which it can be used to record cash discounts received and allowed, are considered in Chapter IV.

PLANT 1.

19— July 1 12	To Sundries X Ltd (weighing machines)	J.1 J.4	250 0 0 85 0 0	19— July 31	By Balance	c/d	335 0 0
			£335 0 0				£335 0 0
Aug. 1	To Balance	b/d	335 0 0				

Notes. (1) The first posting on the Dr. side is described as "To Sundries," because it comes from a composite journal entry and it is therefore impossible to indicate one particular account as having received the corresponding credit entry. The amount of £250 represents the total value assigned by A to all the plant owned by him on July 1; the details showing the composition of this figure will be found in the inventory (that is, priced list or schedule) taken out by A for this purpose.

(2) The second posting on the Dr. side indicates, by the description "to X Ltd", that the double entry is completed by a credit in the account of X Ltd. In most cases that would be a sufficient description of the transaction and in any event the narration in the journal supplies further details if they are required. It is desirable, however, to add brief details of the machine when making this posting to Plant Account because this is the record of the purchase of an asset which may remain in A's books for many years.

(3) An impersonal account, as distinct from a personal account, would not normally be balanced at the end of each month. Such accounts are usually balanced annually or half-yearly, when the books are closed for the purpose of preparing the annual or half-yearly accounts (see Chapters V and VI). Some adjustment of value may in fact be necessary before the balance is carried down. In this case a balance has been carried down at the end of the first month because it is desired to illustrate the extraction of a Trial Balance at that date. In practice the balance could be ascertained, for such a purpose, by inserting totals on each side of the account in pencil and subtracting the smaller total from the larger.

STOCK 2.

19— July 1	To Sundries	J.1	436 0 0				

SALES 3.

				19— July 6	By B	J.2	187 10 0

RETURNS INWARDS 4.

19— July 10	To B	J.2	90 0 0				

Purchases 5.

19— July 7	To Z	J.3	127 10 0				
	"	J.3	156 10 0				
			284 0 0				

Returns Outwards 6.

				19— July 11	By Z	J.3	127 10 0

Discounts 7.

19— July 31	To B	J.2	2 8 9	19— July 29	By Z	J.3	7 16 6

Note. Alternatively, separate accounts could be opened for Discounts Allowed and Discounts Received respectively.

Salaries 8.

19— July 31	To Cash	J.5	25 0 0				

Lighting and Heating 9.

19— July 31	To Cash	J.5	12 10 3				

Insurance 10.

19— July 31	To Cash	J.5	6 5 0				

Stationery 11.

19— July 31	To Cash	J.5	6 2 3				

Bad Debts 12.

19— July 31	To D	J.6	18 2 1				

A. Capital Account 13.

				19— July 1	By Sundries	J.1	880 2 6

Note. Reference to the entry on page 5 of the journal recording the payment of the electricity account, £12 10s. 3d., shows that this related to the quarter ended June 30. This was therefore a liability on July 1, and ought to have been taken into account as such in the opening journal entry from which A's capital was calculated. If A had kept a proper set of books this liability would have been taken into account; the method of making provision for such accrued expenses is dealt with in Chapter V.

It will be observed that as a result of making all these postings from the journal, some of the ledger accounts are open (that is, they have balances remaining on them) whereas others (for the time being at least) have been closed. In the closed accounts the debit entries are exactly equal in total to the credit entries. Further, as every debit entry in the journal was balanced by a credit entry, all the debit postings, in both closed and open accounts, are equal in total to all the credit entries. By subtracting from the totals of all debit or credit postings the totals posted into the closed accounts which are known to agree, it is proved that the total of the debit postings in the open accounts must equal the total of the credit postings in the same or other open accounts.

An account is balanced by totalling the two sides and subtracting the smaller from the larger. In the Cash Account, for example, payments recorded on the credit side totalled £283 11s. and this amount deducted from the total of the debits, £304 4s. 5d., gave a debit balance of £20 13s. 5d. From the point of view of balancing all the debit postings in the ledger against all the credit postings, the debit balance of £20 13s. 5d. is equivalent to all the postings, debit and credit, which go to make it up. It follows that if all the journal entries have been posted, so that the debit postings are equal, in total, to the credit postings, then the debit balances remaining on some of the accounts must also be equal in total to the credit balances on others.

The process of taking out a list of all the balances for the purpose of showing that the debit and credit totals agree is known as extracting a Trial Balance. If applied to the ledger accounts illustrated in the foregoing example the result is as follows:

A

Trial Balance as at July 31, 19—

Ledger	Account	Folio	Dr.	Cr.
Sales	C	S.1	94 3 6	
Bought	M	B.1		81 2 6
	N	2		46 3 9
Cash Book	Cash	C.1	20 13 5	
General	Plant	G.1	335 0 0	
	Stock	2	436 0 0	
	Sales	3		187 10 0
	Returns Inwards	4	90 0 0	
	Purchases	5	284 0 0	
	Returns Outwards	6		127 10 0
	Discounts	7	2 8 9	7 16 6
	Salaries	8	25 0 0	
	Lighting and Heating	9	12 10 3	
	Insurance	10	6 5 0	
	Stationery	11	6 2 3	
	Bad Debts	12	18 2 1	
	A. Capital Account	13		880 2 6
			[illegible]30 5 3	£1,330 5 3

As the totals of the debit and credit columns are the same, the Trial Balance is said to agree. The fact that it does agree goes a long way

towards proving that the postings made to the ledger are arithmetically correct, and the fact that proof can be obtained in this way is one of the great advantages of double-entry book-keeping. In addition, the extraction of a Trial Balance at the date on which the books are to be closed for the year, or half-year, is an essential step in the preparation of the accounts showing the results of trading for that period and the trader's financial position at the end of it. A Trial Balance taken out at any other date serves the useful purpose of providing the trader with a complete schedule of balances due to him from his customers and by him to his suppliers. The Sales Ledger balances are usually listed, totalled and taken into the general Trial Balance as one item, Sundry Debtors. Similarly, the total of the Bought Ledger balances may be referred to as Sundry Creditors.

Had the totals of the Trial Balance not been in agreement, the book-keeper would have known that an error had arisen. This might have been due to any of the following:

(1) *Failure to complete the double entry* (that is, one side of a journal entry having been posted but not the other). The resulting discrepancy would be equal to the amount not posted and this might enable it to be discovered fairly easily by looking through the journal for an item of that amount.

(2) *An item posted to the wrong side* of the appropriate account in the ledger. The resulting discrepancy would be equal to twice the mis-posted amount. For example, had the £25 debited to Salaries Account been posted in error to the credit of that account, it would have shown a credit balance of £25 instead of a debit balance of £25. The totals of the Trial Balance would then have been £1,305 5s. 3d. and £1,355 5s. 3d. respectively; a difference of £50. The error might be discovered by looking for an item of £25—one half of £50.

(3) *A transposition of figures* or other error of commission resulting in an incorrect amount being posted to one side of the ledger. The resulting difference would of course be the difference between the correct and incorrect figures and it would be difficult to discover it except by the process of checking (or calling over) all the postings.

(4) *An error in a cast* (that is, addition) either in the journal (for example, in a composite entry which as a result would itself be out of balance) or in the ledger, resulting in a balance being extracted incorrectly. Such an error is also difficult to discover except by checking all additions in the books.

There are, however, certain types of error which will not be revealed by the disagreement of the Trial Balance. For example:

(1) A transaction might have been omitted entirely from the books, which would then balance but could not be said to present a complete record of the trader's transactions.

(2) An item might have been posted from the journal to the wrong account in the ledger. Had the misposting been to an account of the same class (for example, if the £95 1s. 3d. received from B had been credited in error to the account of C) both the accounts involved would show incorrect balances, but such an error would normally reveal itself in a very short time. (The fact that C's account would

then show a credit balance would in itself suggest to the book-keeper a line of inquiry.) Alternatively, the error might have been one of principle. If, for example, the acquisition of the weighing machine from X Ltd. had been treated as an ordinary purchase of goods for resale and debited to Purchases Account, the error might remain undetected for a long time and would normally only be found upon the books being examined by a competent person, such as a professional accountant. The fact that such an error was made would disclose a lack of knowledge of one of the most important principles of book-keeping, and a book-keeper who could make such an error would not be likely to discover it for himself.

(3) Two or more errors of commission might have equal and opposite effects. The Trial Balance would then agree but the books would contain compensating errors.

The fact that it is possible for errors such as the above to be made and not revealed upon extraction of a Trial Balance should show that it is much better that the books should be kept carefully and accurately in the first place and that undue reliance should not be placed upon the check imposed by a Trial Balance.

QUESTIONS AND EXERCISES

(Key to answers on page 569)

(1) What are the main points that need to be considered in opening a new ledger? What details should appear at the head of each ledger account?

(2) Give the principal advantages and disadvantages of loose-leaf ledgers. Suggest a satisfactory method of indexing for a loose-leaf ledger.

(3) What is a Trial Balance? What are the objects of extracting a Trial Balance?

(4) What are the major sources of error likely to be met in extracting a Trial Balance? What do you understand by: compensating errors; errors of omission; errors of principle?

(5) The following is given you as the Trial Balance extracted from A. Trader's books at April 30.

	£	£
A. Trader—Capital Account		1,556
Drawings	564	
Leasehold Premises	741	
Sales		2,756
Due from Customers		530
Purchases	1,268	
,, Returns	264	
Loan from Bank		250
Creditors	628	
Trade and Office Expenses	784	
Cash at Bank	142	
Salaries and Wages	598	
Stock (January 1)		264
Rent and Rates	465	
Sales Returns		98
	£5,454	£5,454

If, in your opinion, the above statement is incorrect in any particulars, rewrite it, making what corrections you consider necessary. (*L.C. of C. Elem.*).

(6) On June 1, J. Wilson's account in your ledger showed that he was a debtor for £17 10s. 3d. He paid this amount by cheque less a cash discount of 5 per cent on June 5. On June 17 he purchases from you further goods to the value of £21 3s. 9d. Show his account in your ledger as it would appear after balancing on June 30. (*L.C. of C. Elem.*).

(7) On September 1, C. Raeburn purchased goods value £89 10s. from E. Elson. He paid for these goods and was allowed a *cash discount* of 5 per cent on October 8. On October 11 he again purchased goods and was allowed a *trade discount* of 15 per cent from the catalogue price £120.

(*a*) Show E. Elson's Account in Raeburn's ledger for September and October.
(*b*) Explain the terms printed in italic above. (*L.C. of C. Elem.*).

(8) Dealing in order of date with each item shown in the following ledger account, state:
(*a*) What are the transactions recorded.
(*b*) What further entry should be made on January 6.

Black's Sales Ledger

C. SMITH

19—			19—		
Jan. 1	To Goods	50 0 0	Jan. 4	By Returns	10 0 0
			5	Cheque	39 0 0
			5	Discount	1 0 0
		£50 0 0			£50 0 0
Jan. 6	To Cheque returned unpaid	39 0 0			

(*R.S.A. Stage I*).

(9) (*a*) State clearly what you understand by:
(i) Personal Accounts; (ii) Nominal Accounts; (iii) Real Accounts.
(*b*) Copy out the following list of balances, then write against each item the word Personal, Nominal or Real to indicate the type of account:

	£		£
Capital (January 1)	1,400	Lighting and Heating	16
Drawings	120	Furniture and Fittings	150
Bank (Dr. balance)	210	Rent	60
Petty Cash	10	Motor Vans	210
Stock	480	Carriage on Sales	12
R. P. Herbert (Dr. Balance)	74	Purchases	690
A. C. Cole (Cr. balance)	128	Sales	840

(*c*) Open the above accounts in your ledger and insert the balances as at June 1. Then make entries direct into these ledger accounts for the following transactions:

		£ s. d.
June 2	Drew cheque for private expenses	20 0 0
„ 3	Paid A. C. Cole his account at June 1, by cheque	
	Purchased on credit from A. C. Cole goods £80 less 20 per cent trade discount	
„ 4	Paid Electric Light from Petty Cash	3 5 0
„ 6	Sold an office typewriter for cash which was paid into bank	20 0 0
„ 8	Sold goods on credit to R. P. Herbert	42 0 0
	Paid carriage on goods to Herbert from Petty Cash	5 6
	Paid Rent by cheque	30 0 0

N.B.—No subsidiary books are required. Do not balance the accounts. Do not make a Trial Balance. (*L.C. of C. Elem.*).

CHAPTER IV

SUBSIDIARY BOOKS

THE primary function of subsidiary books is to relieve the main journal of all entries which are of a routine or day-to-day character. In a wholesale trader's business the transactions involved will be:

(1) The purchase of goods for resale.
(2) The sale of goods.
(3) Returns and allowances—inwards and outwards.
(4) The receipt and payment of cash.

PURCHASE OF GOODS

If the trader made ten separate purchases of goods from ten different suppliers on the same day and these transactions were all recorded in the journal as shown in Chapter II, there would as a result have been on that day ten debit entries described as purchases and therefore ten different postings to Purchases Account. These ten debit entries would, of course, have been balanced by ten credit entries naming the different suppliers and these would have been posted to the appropriate accounts in the Bought Ledger.

In the course of a single month the debit entries for purchases in a business of this size would run into several hundreds and would occupy that number of lines in the journal and again in Purchases Account, to which each item would have been posted separately.

A Purchases Day Book (or Bought Day Book) is designed to avoid unnecessary repetition and to enable one posting to be made to Purchases Account at the end of the month, while retaining the detailed postings to the Bought Ledger that are necessary to secure a complete record of all transactions. In its simplest form such a book is ruled as follows:

BOUGHT DAY BOOK

Date	*Name*	*Invoice No.*	*Ledger Fo.*	*Amount*		

Entries in the Day Book are made from the invoices received from the suppliers. Before an entry is made the relevant invoice should be checked to ensure that:

(1) It agrees with the order placed for the goods;
(2) The goods in question have actually been received;
(3) The prices charged are correct (the checking involving both quantity and quality);
(4) The calculations which lead up to the actual amount of the invoice,

including the deduction of trade discount, if applicable (but *not* cash discount), are correct.

After the entry has been made the invoice should be filed in such a way that it can be referred to easily at any subsequent time. If the invoices are given serial numbers, to agree with the order in which they are entered in the Day Book, they can be regarded as constituting part of the original record of the transaction; the information written into the Day Book is then the minimum necessary to effect the subsequent posting to the Bought Ledger. On the other hand, if it is not convenient to file the invoices in this order or in some other way which ensures quick and accurate reference to them, it will be advisable to incorporate an additional column in the Day Book in which brief particulars can be entered.

POSTING FROM THE BOUGHT DAY BOOK

At convenient intervals, preferably at least once a day (so that the record in the Bought Ledger is always up to date), the entries made in the Bought Day Book are posted in detail to the *credit* of the appropriate suppliers' accounts in the Bought Ledger. At longer intervals, usually at the end of each calendar month, the "amount" column is totalled and the final total is ruled off and posted to the *debit* of Purchases Account in the General Ledger. As this one debit posting is equal to the total of all the credit postings from the Day Book, the fundamental principle of double-entry book-keeping is safeguarded and the ledgers remain "in balance." An illustration of this procedure will be found in the comprehensive example later in this chapter.

VARIATIONS IN BOUGHT DAY BOOKS

When the number of transactions is very considerable and the book-keeping work has to be divided between several book-keepers, it may not be expedient to record all purchases in one Bought Day Book. If the

BOUGHT

Date		Name	Folio	Amount	Purchases
19—					
Jan.	1	A & Co.	2	27 6 3	27 6 3
		British Railways	1	10 1 6	
	3	A & Co.	2	110 0 0	
	6	B Ltd.	5	22 2 8	22 2 8
	10	C Brothers, Ltd.	8	91 9 11	91 9 11
	11	A & Co.	2	52 10 0	
	16	D & Co., Ltd.	10	38 2 5	38 2 5
	21	A & Co.	2	19 4 6	19 4 6
	31	E. Hankers, Ltd.	12	29 2 7	
				£399 19 10	£198 5 9
					GL 10

business is divided into several departments a separate Day Book can be kept for each of them. This, besides dividing the book-keeping work, has the additional advantage that the invoices relating to each department will be filed separately and can be referred to without interrupting the work of the other departments.

Alternatively, there can be two Day Books, labelled "Monday, Wednesday and Friday" and "Tuesday, Thursday and Saturday" respectively (or M.W.F. and T.T.S. for short). This enables one of the books to be used each day for entering the invoices received while the ledger-keeper is posting the entries for the preceding day from the other book to the Bought Ledger. Next day the books are exchanged, and so on. At the end of the month either separate postings can be made to Purchases Account, or the total of one book can be carried into the other and the grand total posted.

Whatever system is used for extending the number of Day Books, all the detailed postings should be made into the same Bought Ledger or set of Bought Ledgers so that all purchases from a given supplier appear in one account, which will record the trader's total indebtedness to that supplier at any one time.

A further variation in the form of the Bought Day Book is found when it is used to record certain transactions other than the purchase of goods for resale. For example, if the trader maintains credit accounts with the Railways and other carriers for the carriage of his goods, or if he buys an item of plant from a supplier from whom he normally buys goods for resale, these transactions will give rise to credit entries in the Bought Ledger, but the relevant debit entries will be in accounts other than Purchases Account. As the Bought Day Book becomes the principal source from which credit postings are made to the Bought Ledger it is desirable that, as far as possible, it should be the source of all credit postings thereto. This can be effected by the use of analysis columns:

DAY BOOK

Carriage	*Plant*	*Sundries*		
		Description	*Folio*	*Amount*
10 1 6				
	110 0 0			
		Office Equipment—Steel Cabinets	GL 80	52 10 0
29 2 7				
£39 4 1	£110 0 0			£52 10 0
GL 15	GL 70			

It will be observed that three analysis columns have been provided for types of expenditure—Purchases, Carriage and Plant—which are expected to recur frequently. The name of each of these columns indicates the nature of the transactions recorded in it and the monthly *totals* are posted to the debit of Purchases Account, Carriage Account and Plant Account respectively in the General Ledger. A final column is then provided for recording transactions of a kind which does not warrant the provision of a specific analysis column. This column cannot be posted in total, as it may contain several entries involving postings to various other accounts in the General Ledger. Consequently this column is provided with a space in which brief particulars of the invoice are entered, and it is preceded by a folio column so that the amounts can be posted in detail to the General Ledger.

The number of analysis columns to be provided will depend on the nature and size of the business; it need not be restricted to the three specific and one sundries column illustrated above. Books can be obtained with rulings for as many as thirty analysis columns. Whatever the number of columns used for specific types of expenditure there should always be one headed "Sundries" or "Unallocated" and provided with a folio column to enable detailed postings to be made from it.

The sundries column should always be totalled even though the total does not have to be posted. The totals of all the analysis columns, including the sundries column, can then be cross-cast and shown to agree with the total of the principal or "amount" column. This agreement of the cross-cast should be made at the foot of each page in the Day Book before the page totals are carried forward to the top of the next page. At the end of the month the cross-cast is agreed before any totals are posted to the General Ledger. In this way a valuable check upon the accuracy of the additions is obtained.

The agreement of the cross-cast also proves that the amounts posted to the debit of the General Ledger are equal in total to the detailed items posted to the credit of the Bought Ledger. The double entry has therefore been completed.

RECORDING OF SALES

A Sales Day Book which is designed to relieve the journal of the detailed record of goods sold is similar in principle to the first form of Bought Day Book illustrated on page 43.

SALES DAY BOOK

Date	*Name*	*Invoice No.*	*Ledger Fo.*	*Amount*		

In the days when invoices were written out by hand, the Sales Day Book was frequently used as a medium for drafting the invoices, which were then copied from the particulars recorded in the book and dispatched

to the customers. A further column for particulars was then incorporated in the book. As it is now usual to issue typewritten invoices and to retain a carbon copy which can be filed and made part of the book-keeping record, the particulars column is not, as a rule, required. No difficulty should be experienced in filing the copy invoices in the sequence of the entries in the Day Book, for if they are also required to be filed in some other order, additional copies can be made for that purpose. Where that is done, however, differently coloured "flimsies" should be used for the various sets of copies, so that the book-keeper does not inadvertently make two or more entries for the same transaction.

VARIATIONS IN SALES DAY BOOKS

Debit postings in the Sales Ledger will nearly always consist of the record of goods sold to customers; the necessity of supplying the Day Book with analysis columns to cover expenses such as carriage, and capital transactions such as purchase of plant, does not arise. When it is necessary to record the sale of a capital asset (such as the sale of an old machine), this should be made the subject of a journal entry or, alternatively, it may be possible to post the amount of cash received from the debit of Cash Account to the credit of Plant Account without passing the transaction through the Sales Ledger. Whatever method is adopted, the greatest care must be taken to see that the monthly total of the Sales Day Book posted to the credit of Sales Account does not include anything other than ordinary sales of goods.

When a business is divided into several departments and it is desired to record the sales of each department separately, either separate Day Books can be kept for each department or one book can be used, with appropriate analysis columns.

SALES DAY BOOK

Date	*Name*	*Inv. No.*	*Ledger Fo.*	*Amount*	*Dept. A*	*Dept. B*	*Dept. C*	*Dept. D*

The monthly totals of the "amount" column will be posted to the credit of Sales Account in the General Ledger and the analysis columns will be left unposted unless it is desired to prepare Departmental Trading Accounts (see Chapter XVII).

RETURNS

Provision must be made for recording goods returned to suppliers or from customers and for other credit notes and allowances that may arise from time to time. The ruling of a Returns Book must follow closely that of the appropriate Day Book; for that reason, in businesses of moderate size a few pages at the back of each Day Book are sometimes used for that purpose. Alternatively, entries for credit notes are sometimes made in red ink in the current pages of the Day Book; a red-ink figure in the Bought Day Book is then posted to the debit of the supplier's

account in the Bought Ledger and, being treated as a negative sum in the casts of the Day Book, has the effect of reducing the totals that would otherwise be posted to the General Ledger accounts for Purchases. This method is not recommended, as it is liable to lead to errors in posting and there is no record in Purchases Account and Sales Account of the actual amount of credit notes received and given respectively during a given period.

If an analysed Bought Day Book is used, the appropriate Returns Book (or back pages of the Day Book) will appear as follows:

RETURNS OUTWARDS (or PURCHASES RETURNS) BOOK

Date	*Name*	*C/N No.*	*Led. Fo.*	*Amount*	*Purchases*	*Carriage*	*Plant*	*Sundries*		
								Details	*Fo.*	*Amount*

The double entry is completed by posting the items in the "amount" column to the debit of the appropriate accounts in the Bought Ledger, while the monthly totals are posted to the credit of the relative General Ledger accounts. The credit posting from the "purchases" column is preferably made to a separate account for Returns Outwards.

The Sales Returns Book (where there is no departmental analysis) will appear as follows:

RETURNS INWARDS (or SALES RETURNS) BOOK

Date	*Name*	*C/N No.*	*Ledger Fo.*	*Amount*

The detailed amounts will be posted to the appropriate accounts in the Sales Ledger, while the monthly total is debited to a Returns Inwards Account in the General Ledger.

Although these books are usually known as Returns Books, it must be noted that they are used to record all credit notes which affect a trader's indebtedness to his suppliers and his customers' indebtedness to him respectively. Such credit notes may be received or given where for any reason the amount of an invoice already entered in the books has to be amended. When an invoice has been entered incorrectly in the books, it is usually better to make an entry in the Returns Book cancelling the original incorrect entry; an additional entry is then made in the Day Book for the correct amount.

It should be noted that whatever entries are made in the Day Books and Returns Books in order to effect adjustments of this nature, they will be posted therefrom to the appropriate personal account in the Bought Ledger or Sales Ledger. They should therefore be made in such a way that the least confusion will be caused when checking Bought Ledger

accounts against monthly statements received from suppliers or when issuing monthly statements to customers, as the case may be.

Although the duty of the book-keeper as such may be confined to making the appropriate record of any credit note—inwards or outwards—that may be passed to him for that purpose, the proprietor of the business should see that there is a proper system of supervision of the issue of credit notes to customers. It may be desirable to make a rule that the book-keeper is to make no entry for such an allowance unless the carbon copy has been initialled by the proprietor or by some responsible official to whom he has delegated this power.

RECEIPT AND PAYMENT OF CASH

A comprehensive system of book-keeping has to record cash transactions of two types:

(1) Those involving cash (that is, notes and coins) in the strict sense.

(2) Payments into the trader's banking account and cheques drawn upon that account.

Primarily, the relationship between a trader and his bankers is that of creditor and debtor (or, if his account is overdrawn, debtor and creditor). If strict theory were followed, therefore, the account in the trader's books which recorded his transactions with his bankers would be regarded as a personal account and found in one of the ledgers. Nevertheless, the real purpose of the banking account is to act as a depository for the trader's cash balance.

In a wholesale business most remittances from customers will take the form of cheques which must be paid into a banking account to enable them to be collected or "cleared." Similarly, the trader will settle most of his own liabilities to his suppliers by drawing cheques on his own banking account. As all amounts received from customers, whether by cheque or otherwise, have to be credited to their accounts in the Sales Ledger and all amounts paid to suppliers have to be debited to the appropriate accounts in the Bought Ledger, it will be found convenient to record them all in the Cash Book. The ruling of the Cash Book will then require some modification depending on whether:

(1) all receipts are banked and all payments other than Petty Cash items are made by cheque, or

(2) cash receipts are partially banked and a balance of cash is carried in addition to the bank balance.

DISCOUNTS

It has been seen that whereas trade discount (which does not depend on prompt payment) is deducted from an invoice before it is entered in the appropriate Day Book and can therefore be ignored in the subsequent posting to the ledger, cash discount arises, and can only be recorded, at the time when the account is settled. Cash discount is allowed to a customer at the time when he settles his account; the benefit of cash discount is received at the time when a cheque is sent to a supplier in payment of his account.

When the journal was used to record these transactions it was possible

(see Chapter II) to make a composite entry for cash and discount which enabled the combined amount to be posted to the Personal Ledger. It is desirable that the same process should be possible when a Cash Book is used to record all receipts and payments of cash. This is quite easily effected by providing an additional column, headed "Discount," on each side of the Cash Book.

Discount deducted by a customer when paying his account is then entered in the debit discount column next to the net amount of cash received, and the two amounts, cash and discount, either separately or in total, are posted to the credit of the customer's account in the Sales Ledger. Similarly, discount deducted from an amount paid to a supplier is entered in the credit discount column and posted, together with the amount of cash paid, to the debit of the appropriate account in the Bought Ledger.

CASH BOOK

It is generally admitted that there are many advantages to be gained by insisting that all cash received (whether cheques, notes or coin) is paid into the bank daily and that all payments except very small cash disbursements are made by cheque. The small cash disbursements are made out of a fund of cash provided periodically by drawing cheques for petty cash, and are recorded in a separate Petty Cash Book. The Cash Book proper will then be ruled as follows:

Date	*Name*	*Fo.*	*Dis-count*	*Details*	*Bank*	*Date*	*Name*	*Fo.*	*Dis-count*	*Details*	*Bank*

The use of this book is illustrated in the comprehensive example later in this chapter. It will be noted that two cash columns are provided on each side. This is because:

(1) On the debit side, the total of the amounts paid into the bank on each occasion should be shown, to facilitate checking the Cash Book against the Bank Pass Book, wherein only the total of each lodgment will appear.

(2) On the credit side some cheques will be drawn which will require to be posted to more than one account in the ledger. For example, at the end of a week one cheque may be drawn and encashed for a sum required to pay wages, office salaries, petty cash and other items, all of which have to be recorded separately in the trader's books.

The middle columns, used for these details of lodgments at the bank and cheques drawn respectively, need not be cast. The principal cash columns constitute the true record of the Bank Account; they must be cast and a balance carried forward at the end of each month to the next page of the book. Before this balance is actually inserted in ink, however,

the Cash Book should be reconciled with the Bank Pass Book in the manner indicated later in this chapter.

The discount columns must also be cast and monthly totals shown. These columns are not balanced, however, as they do not constitute a ledger account in themselves (as in the case of the main cash columns) but merely serve a similar function to that served by Day Books. The monthly totals must therefore be posted to the Discount Account or Accounts in the General Ledger.

The detailed amounts in the debit discount column have been posted to the credit of the individual customers' accounts in the Sales Ledger; to complete the double entry, therefore, the total must be debited to Discount Account or to Discount Allowed Account if, as is preferable, separate Discount Accounts are maintained. Similarly, the detailed amounts in the credit discount column have been debited to the individual suppliers in the Bought Ledger, and the total for the month must therefore be credited to Discount Account or to Discount Received Account. This is a simple rule to remember, but it is one which requires care in application, for it may appear, at first sight, to be contrary to the general rule that an amount appearing on one side of the Cash Book is posted to the other side of the ledger in order to complete the double entry.

CASH AND BANK BOOK

Where for any reason it is not considered necessary or desirable to pay all cash receipts into the bank and some payments are therefore made out of the general balance of cash in hand, it is necessary either to keep separate Cash Books for cash and bank transactions respectively or to combine the record in one book. The three-column Cash Book already considered as a record of bank transactions can be used for a combined record.

Example

From the following particulars write up A. Bondman's Cash Book for the week commencing July 5, and balance the Cash Book as at July 10.

July 5 Cash in hand £15 10s. 0d., and in bank £176 3s. 9d.
,, 5 Paid by cheque to F. Abbott his account of £46 10s. 6d. less 5 per cent cash discount.
,, 6 Paid in cash, postage stamps £1 10s. 6d., new typewriter ribbons 3s.
,, 7 Purchased goods for cheque £10 9s. 2d.
Received cheque from R. Beal in payment of his account of £37 3s. 5d., less $2\frac{1}{2}$ per cent cash discount, and paid the cheque into bank.
,, 8 Purchased for cheque new office desk £9 10s. 0d.
,, 10 Paid wages in cash £3 1s. 0d.
Cash sales for week £56 7s. 2d. paid into bank.
Withdrew from bank for office purposes £5.
Withdrew from bank for self £6. (*L.C. of C. Elem.*)

			Discount	Cash	Bank
19—					
July 5	To Balances	b/f		15 10 0	176 3 9
7	R. Beal		18 7		36 4 10
10	Cash sales				56 7 2
	Bank	₵		5 0 0	
			18 7	£20 10 0	268 15 9
			(posted to debit of Discount Allowed Account)		

Notes. (1) The Cash Book would not normally be balanced and ruled off at the end of a week. This would be done, and the discount totals would be posted to the General Ledger, at the end of each calendar month.

(2) The balance of the bank columns should be reconciled with the balance shown by the Bank Pass Book or statement before it is finally entered in the Cash Book and carried forward to the next period.

(3) All the entries in any of the three debit and credit columns are posted to ledger accounts except:

(*a*) the opening and closing balances;

(*b*) a cheque cashed and paid into office cash, or, conversely, surplus cash paid into the bank (not illustrated in this example).

No posting to the ledger is necessary in these cases as the double entry is complete in the Cash Book. In the case of cash paid to bank, or vice versa, the entries are said to "contra" and the fact that no further posting is required is indicated by the sign ₵ in the ledger folio column.

(4) When an amount is received in cash but is immediately paid into the bank, the original entry can be made in the debit bank column; it is not necessary to show the amount as received in the debit cash column and then transferred from cash to bank, which would involve three entries instead of one. The record of cash sales has therefore been made in this way. If, alternatively, the amounts of cash sales had been given daily, with a note that the total of £56 7s. 2d. was paid into the bank at the end of the week, the daily receipts would have been shown in the debit cash column, with a transfer or contra of £56 7s. 2d. from cash to bank on July 10.

(5) The items "Cash sales" and "Cash purchases" will be posted to the credit of Sales Account and the debit of Purchases Account respectively. It is not necessary to pass these transactions through the Sales Ledger or Bought Ledger; indeed, in this case the names of the customers and supplier concerned are not known (or have not been recorded).

			Discount	Cash	Bank
19—					
July 5	By F. Abbott		2 6 6		44 4 0
6	Postage stamps			1 10 6	
	Typewriter ribbons			3 0	
7	Cash purchase				10 9 2
8	Office furniture (desk)				9 10 0
10	Wages			3 1 0	
	Cash	¢			5 0 0
	A. B. drawings				6 0 0
	Balances	c/d		15 15 6	193 12 7
			£2 6 6	£20 10 0	£268 15 9
			(posted to credit of Discount Received Account)		

RECONCILING THE BANK BALANCE

Although all amounts paid into the banking account and all cheques drawn on that account have been recorded correctly in the Cash Book, it will rarely be found that the balance at bank (or overdraft) as shown by the Cash Book agrees with the balance recorded in the bank's books as shown by the Pass Book or statement issued by the bank. There are many reasons why these balances may not agree; these fall into two classes, according to whether:

(1) they call for additional entries to be made in the Cash Book before it is finally balanced; or

(2) no amendment is necessary, the item being one which automatically corrects itself in the next period.

The principal items which appear in the Pass Book and call for corresponding entries to be made in the Cash Book are as follows:

(1) Bank charges; for example, for supplying cheque books, for discounting bills and other specific services, interest on an overdrawn account (generally charged by the bank at the end of each quarter or half-year) and general bank charges for maintaining an account in which the average balance carried is not sufficient to cover the costs incurred by the bank.

(2) Payments made by the bank under Standing or Bankers' Orders, generally of regular fixed amounts, such as monthly salaries. The book-keeper should, of course, be aware of these orders and may have entered the amounts already on the correct dates; nevertheless, as the payments side of the Cash Book is usually written up by reference to the counterfoils of the cheque books used, it is sometimes found that these items are overlooked by the book-keeper until they are revealed when the Pass Book entries are checked against the Cash Book.

(3) Cheques that have been paid in but have been returned by the bank unpaid for any reason. Sometimes this non-payment of a cheque is due to a technicality such as an incorrect signature or endorsement. When the fault has been remedied the cheque will be paid in again and this time will presumably be paid. In that event, three entries will appear in the Pass Book (two debit and one credit, looking at it from the trader's point of view) and the agreement of the balances will not be affected, provided the cheque was re-presented before the date on which the balance was struck. If the balancing date intervenes, the amount involved will have to be taken into account in the reconciliation; no correction of the Cash Book is necessary.

On the other hand, the dishonouring of a cheque may be due to the fact that the customer who drew it and sent it to the trader in settlement of his account had not a sufficient balance at his own bank to meet it. In that case a longer interval may elapse before the cheque is re-presented; it may even be dishonoured more than once before it is ultimately paid, or it may never be paid at all.

These circumstances should be recorded in the trader's Cash Book so that the customer's account in the Sales Ledger will then contain a full record of this unfortunate occurrence (which will, of course, be borne in mind when considering what further credit, if any, can be given to the customer). The dishonour of the cheque is recorded by an entry on the credit or payments side of the Cash Book, whence it is posted to the debit of the customer's account in the Sales Ledger (where it has the effect of cancelling out the credit posting of the cheque when it was first received).

(4) The detailed checking of the Cash Book against the Pass Book which is necessary to bring the two balances into line may reveal errors either in the amounts entered in the Cash Book or in the additions of the bank columns. These must be corrected before the final balance is inserted.

On the other hand, the following circumstances will cause the balances to differ but do not call for correcting entries:

(1) Cheques outstanding, that is, cheques drawn by the trader and entered in his Cash Book as paid out but not yet presented to his bank for payment, and therefore not yet debited to his account in the bank's books. Cheques drawn during the last few days of the period, unless cashed at the same branch of the bank, will nearly always prove to be outstanding, since the operation of clearing the cheque may take several days, in addition to the delay involved in forwarding the cheque by post to the payee and possible delay on his part in paying it into his bank.

Such cheques will ordinarily be presented during the first week or so of the next period and thus, subject to any further transactions that have taken place, will bring the two balances into line.

(2) Cheques and other articles paid in by the trader but not yet credited in his Pass Book. This source of difference is less usual as most banks in England credit cheques and other amounts on the day on which

they are paid in (reserving the right not to allow the trader to draw against such cheques until they have been cleared). These amounts, if not credited, should also appear in the Pass Book early in the next period.

(3) Cheques paid in, returned unpaid but again paid in during the next period and then met, as explained in (3) above. Such items are similar in effect to cheques paid in but not yet credited by the bank.

The distinction between items which call for immediate entries in the Cash Book and those which do not, and the form of the Reconciliation Statement which should be drawn up to explain the final difference between the balances, are illustrated in the following example.

Example

On December 31 a trader's Cash Book, on being provisionally added up and balanced, showed a balance at bank amounting to £397 6s. 3d. On obtaining the monthly statement from the trader's bank, it was found that the balance thereon as on December 31 was £424 15s. 5d. The difference between these two figures was found to be attributable to the following:

(1) On December 6 a charge of 12s. for a new cheque book had been made by the bank.

(2) A cheque received from B. Sykes on December 10 for £23 7s. 6d. and paid into the bank had been returned marked "No Account."

(3) An annual subscription of £1 1s. 0d. to the Traders' Mutual Benefit Association had been paid by Bankers' Order on December 15.

(4) The following cheques issued by the trader and entered in the Cash Book had not been presented for payment:

December	20	–	H. Jones	£16 3s. 11d.
	24	–	X Wines & Spirits, Ltd.	£28 9s. 7d.
	26	–	Y Chemists, Ltd.	19s. 11d.
	30	–	B. Smith & Sons	£59 6s. 3d.

(5) A cheque for £52 10s. 0d. received on December 24 from P. Williams in favour of A. B. Trader had been endorsed "A. Trader" and paid in to the bank account. It was returned by the bank on December 27 marked "Endorsement irregular," was re-endorsed "A. B. Trader" and again paid in on January 2. The return of the cheque had not been recorded in the Cash Book on December 27.

Adjustment of Cash Book Balance

								£	s.	d.
	Provisional balance of Cash Book							397	6	3
Less	Amounts to be entered as paid out:									
	December	6	Bank Charges		12	0				
		10	B. Sykes, dishonoured	23	7	6				
		15	Subscription, T.M.B.A.	1	1	0				
								25	0	6
								£372	5	9

Reconciliation of Cash Book and Bank Balances

			£ s. d.
	Cash Book Balance (adjusted)		372 5 9
Add	Cheques drawn not presented:		
	H. Jones	16 3 11	
	Wines & Spirits, Ltd.	28 9 7	
	Y Chemists, Ltd.	19 11	
	B. Smith & Sons	59 6 3	
			104 19 8
			£477 5 5
Less	Cheque re-presented, not yet credited, P. Williams		52 10 0
	Bank Statement Balance		£424 15 5

PETTY CASH BOOK

Even though a trader may adhere to the rule that all cash received is paid into his banking account and all payments are made, as far as possible, by cheque, there will usually be some small disbursements in the nature of office expenses for which cheques cannot be drawn and for which a small balance of cash in hand must be made available. This cash balance is known as Petty Cash; it should be kept under lock and key in a suitable box and is usually entrusted to the care of one member of the staff, known as the Petty Cashier, who must keep an account of his transactions for two distinct reasons:

(1) As an explanation of the amounts received and disbursed, and to enable the balance which ought to be in hand at any time to be ascertained and checked.

(2) To enable the expenditure to be properly recorded according to its nature and posted to the appropriate accounts in the ledger.

With regard to (1), any book kept in the form of a ledger account or Cash Book, showing money received on the debit side and money paid on the credit side, could be added up and balanced and the amount of cash in the petty cash box should agree with this balance. This checking process will be made much easier, however, if the petty cash is maintained on the Imprest system. At the outset, the petty cashier is given a sufficient "float" of cash, which he enters as his first receipt. He has to obtain a receipt or voucher for all amounts paid out. At convenient intervals, usually weekly, he presents his outstanding vouchers to the cashier, generally summarizing the amounts on a covering slip of paper, or docket, and is given in exchange cash equal to the total. With the balance still in hand in his box this exactly restores his original float. The same procedure is repeated next week.

If this system is used, the balance in hand can be checked by the principal cashier at any time, since the total of the money in the box plus the value of the vouchers not yet handed over must always equal the float or imprest. The system has the further advantage that the balance in hand at any time can never exceed the amount of the fixed float.

When this system is not used and the petty cashier is allowed to ask for round-sum amounts at frequent intervals, it is possible for a substantial balance to be accumulated.

The ruling of the Petty Cash Book, on the other hand, does not depend upon whether the imprest system is used or not. A simple ledger account ruling shows the amounts received and paid, and the balance at any time, but it does not lend itself to any convenient method of allocating the expenditure. Although amounts paid by the petty cashier are usually small individually, they may amount in total to a considerable sum and cover expenses of a widely differing nature. The payments side of the book (the credit side) should therefore be provided with analysis columns.

Example

Rule out a Petty Cash Book, providing separate columns for Carriage, Postages and Telegrams, Office Expenses, Sundry Expenses; and enter therein the following items:

			£	s.	d.
May	16	Cash in hand (imprest system)	10	0	0
	16	Paid carriage on parcels by rail		12	6
	17	Purchased postage stamps £3 10s., telegrams		3	6
	18	Paid for insertion of vacancy advertisement		10	6
	19	Paid office window cleaners		3	0
	19	Refunded (on cash sale) to H. Sloan	1	5	0
	20	Paid carriers' account £2 1s. 3d., office requisites		4	2
	21	Periodicals and papers 2s., parcels postage		7	9

Balance the Petty Cash Book as on May 21 on the assumption that it is kept on the imprest system and that the necessary refund is made on that date. (*L.C. of C. Elem.*).

PETTY CASH BOOK

RECEIPTS			PAYMENTS							
Date	*Fo.*	*Amount*	*Date*	*Details*	*Total*	*Carriage*	*Postage and Telegrams*	*Office Expenses*	*Fo.*	*Sundries*
19— May 16	b/f	10 0 0	19— May 16	Rly. carriage on parcels	12 6	12 6				
21	CB	8 19 8	17	Postage stamps	3 10 0		3 10 0			
			17	Telegrams	3 6		3 6			
			18	Advertisement	10 6			10 6		
			19	Office window cleaners	3 0			3 0		
			19	Cash sale refund (H. Sloan)	1 5 0					1 5 0
			20	Carriers	2 1 3	2 1 3				
			20	Sundry office requisites	4 2			4 2		
			21	Periodicals and newspapers	2 0			2 0		
			21	Parcels post	7 9	7 9				
					8 19 8					
				Balance c/d	10 0 0					
		£18 19 8			£18 19 8	£3 1 6	£3 13 6	19 8		£1 5 0

(*Note.* The Petty Cash Book would not normally be balanced until the end of the month.)

The debit entry for £8 19s. 8d. cash received on May 21 will be balanced by a credit entry for the same amount in the General Cash Book; these two entries are folioed against each other and in that respect complete the double entry. When the Petty Cash Book is kept in this way it constitutes part of the double-entry system of book-keeping, and the balance carried down at the date on which the books as a whole are balanced will have to be entered in the Trial Balance. In this respect the Petty Cash Book (like the Cash Book) is equivalent to a ledger account.

Sometimes the Petty Cash Book is treated merely as a memorandum book and excluded from the double entry. In that event the amounts drawn for petty cash will be posted from the General Cash Book to the debit of a Petty Cash Account in the General Ledger. When the books are balanced at the end of the year a summary of the petty cash expenditure will then be built up from the details in the Petty Cash Book and the total expenditure for the year under each heading will be credited to Petty Cash Account and debited to the appropriate expense account in the General Ledger. This will leave a balance on Petty Cash Account equal to the balance in hand at the end of the year, and this balance will, of course, be taken into account in the Trial Balance.

COMPREHENSIVE EXAMPLE

On January 1, B. Abbott, a wholesale trader, had the following assets: Freehold Premises, £2,000; Fixtures and Fittings, £500; Stock-in-Trade, £836 7s. 9d.; Sundry Debtors, £229 13s. 10d. (C. White, £135 7s. 2d.; Blacksmiths, Ltd., £94 6s. 8d.); Cash at Bank, £432 1s. 11d.; Cash in Hand (Petty Cash), £10.

He owed the following amounts to Sundry Creditors: H. Smith, £202 1s.; D. Wright & Sons, £67 2s. 8d.; British Railways, £19 8s.

During the month of January he had the following transactions:

			£	s.	d.
Jan.	2	Sold goods to C. White	97	10	0
		Bought goods from D. Wright & Sons	17	2	6
		Bought goods from Cooper & Co.		19	10
,,	3	Sold goods to R. Brown & Sons £38 17s. 0d. Less trade discount £9 14s. 3d.	29	2	9
		Bought from W. Archer, Ltd., a new show-case	97	10	0
		And received a credit note (in respect of an old show-case taken in part exchange) for	20	0	0
		Cashed cheque (in respect of wages £15, personal drawings £10)	25	0	0
		Received credit note from D. Wright & Sons, being an allowance from the amount of their invoice dated Jan. 2, the goods not being up to standard	3	2	6
,,	5	Sold goods to Green & Co.	62	5	0
,,	6	Bought goods from Plowman & Co. subject to special cash discount of 5 per cent if paid within one week	152	0	0

			£	s.	d.
Jan.	6	Received cheque from C. White in respect of the balance due from him on Jan. 1 less cash discount of 2½ per cent.			
		Paid this cheque into the bank, together with cash received in respect of a cash sale	5	0	0
		Sold goods to C. White	48	2	1
,,	7	Green & Co. returned the invoice rendered to them on Jan. 5, as it was incorrectly priced. Issued to them a new invoice for	54	1	6
		And a credit note to cancel the old invoice	62	5	0
,,	10	Paid the following accounts:			
		H. Smith (less 3 per cent cash discount)	202	1	0
		D. Wright & Sons (net)	67	2	8
		British Railways	19	8	0
		Drew cheque (in respect of wages £16 10s., personal drawings £10)	26	10	0
		Sold goods to Gray Brothers, Ltd.	102	6	8
		Sent R. Brown & Sons a credit note for £20, less trade discount 25 per cent, in respect of goods stolen in transit	15	0	0
,,	12	Bought goods from D. Wright & Sons	69	10	2
,,	13	Paid Plowman & Co. the amount owing to them, deducting cash discount at 5 per cent.			
,,	17	Drew cheque (in respect of wages £15 10s., personal drawings £10)	25	10	0
,,	18	Bought goods from Blacksmiths, Ltd. (net)	34	5	0
,,	20	Blacksmiths, Ltd., settled the balance due from them after deducting cash discount at 2½ per cent and setting off the balance due to them as a contra.			
		Received cheque from Gray Brothers, Ltd., in settlement of their account (less discount)	97	4	4
		Paid W. Archer, Ltd., the balance due to them.			
,,	22	Sent cheque to Quill & Quarto, Ltd., in respect of stationery purchased from them (no account for Q. & Q., Ltd., is maintained in the Bought Ledger).	6	5	0
,,	24	Drew cheque (in respect of wages £16, personal drawings £10)	26	0	0
,,	25	Paid into bank cash sales amounting to	7	10	0
		Received account from British Railways in respect of carriage of goods bought from Plowman & Co.	26	2	3
,,	31	The petty cashier produced vouchers for the following amounts disbursed during the month:			

			£	s.	d.
Jan.	3	Postage stamps	1	0	0
,,	8	Office expenses		3	4
,,	10	Stationery		5	6

Jan. 17	Carriage		10	0
„ 21	Cooper & Co. (Bought Ledger Account)		19	10
	Poundage on postal order to Cooper & Co.			2
„ 24	Cash purchase		16	11
	Office cleaning		17	6
	Milk for warehouse cat		2	6
	Postage stamps	1	0	0

Jan. 31	Drew cheque (in respect of wages £17, personal drawings £15, and petty cash £5 15s. 9d.)	37	15	9
	Paid R. Scratchett (book-keeper) his salary for the month, by cheque	25	0	0

It is required: (1) To draft a journal entry incorporating Abbott's assets and liabilities on January 1 and to post therefrom to the appropriate ledger accounts. (2) To record the transactions of the month in the appropriate subsidiary books, post therefrom to the ledgers and to extract a Trial Balance on January 31.

Books of B. Abbott

JOURNAL *Page* 1

19—									
Jan. 1	Freehold Premises Dr.	GL 3	2,000	0	0				
	Fixtures and Fittings „	GL 4	500	0	0				
	Stock-in-Trade „	GL 5	836	7	9				
	C. White „	SL 1	135	7	2				
	Blacksmiths Ltd. „	SL 2	94	6	8				
	Cash at Bank „	CB 1	432	1	11				
	Petty Cash „	PCB 1	10	0	0				
	To H. Smith	BL 1				202	1	0	
	D. Wright & Sons	BL 2				67	2	8	
	British Railways	BL 3				19	8	0	
	B. Abbott, Capital A/c	GL 1				3,719	11	10	
	being assets, liabilities and capital as at this date		£4,008	3	6	£4,008	3	6	
Jan. 20	Blacksmiths, Ltd. Dr.	BL 7	34	5	0				
	To Blacksmiths, Ltd.	SL 3				34	5	0	
	being settlement of Bought Ledger Account by contra								

Notes. (1) The first entry carries out the instruction to incorporate the assets and liabilities on January 1 in Abbott's books. Had he been keeping a proper set of books these would have been the balances appearing in his ledgers on that date.

The excess of the assets over the liabilities, £3,719 11s. 10d., represents his capital and is credited to his Capital Account. The opening journal entry is thus made to balance and represents, in effect, a Trial Balance of the books after they have been opened on January 1 but before any subsequent transactions are recorded. As all further transactions will be recorded by double-entry book-keeping, the books should henceforth remain in balance and will exhibit a full record of the trader's business activities.

As the first journal entry is a composite entry it is totalled and balanced off to show that the debit and credit postings are in fact in agreement.

(2) The transfer from one ledger account to another, to give effect to the settlement "by contra," is recorded in the second entry in pursuance of the rule that all entries in ledger accounts (other than the carrying down of balances) should be made by posting from a book of prime entry. In practice such entries are sometimes made by direct transfer in the ledgers, but that is not a system that is to be recommended.

SALES DAY BOOK 1.

19—			
Jan. 2	C. White	1	97 10 0
3	R. Brown & Sons	3	29 2 9
5	Green & Co.	4	62 5 0
6	C. White	1	48 2 1
7	Green & Co.	4	54 1 6
10	Gray Bros., Ltd.	5	102 6 8
			£393 8 0
			GL 9

Note. It will be observed that the entries in the Sales Day Book are restricted to those recording the sale of goods in the ordinary course of business. The copy invoices will be filed and will give full details of each transaction; the Day Book entries are therefore restricted to the minimum necessary to form a basis for the subsequent ledger postings.

The individual amounts are posted to the *debit* of the customers' accounts in the Sales Ledger; the double entry is therefore completed at the end of the month by posting the total for the month to the *credit* of Sales Account in the General Ledger.

BOUGHT DAY BOOK 1.

Date	*Name*	*Fo.*	*Amount*	*Purchases*	*Carriage*	*Sundries*		
19—								
Jan. 2	D. Wright & Sons	2	17 2 6	17 2 6				
	Cooper & Co.	4	19 10	19 10				
3	W. Archer, Ltd.	5	97 10 0			Fixtures and Fittings (show-case)	GL 4	97 10 0
6	Plowman & Co.	6	153 0 0	153 0 0				
12	D. Wright & Sons	2	69 10 2	69 10 2				
18	Blacksmiths, Ltd	7	34 5 0	34 5 0				
25	British Railways	3	26 2 3		26 2 3			
			£398 9 9	£274 17 6	£26 2 3			£97 10 0
				GL 10	GL 15			

Note. The chief function of the Bought Day Book is to record the purchase of goods for resale. The opening journal entry shows, however, that there is already one ledger account for the railways. Invoices for carriage will, therefore, pass through this Day Book and will have to be distinguished from ordinary invoices for purchases. The Day Book is therefore provided with suitable analysis columns, including one for Sundries, which in this instance is used for recording the acquisition of the new show-case.

The individual items in this Day Book all appear in the Amount column and are posted therefrom to the credit of the appropriate

personal account in the Bought Ledger. The double entry is completed at the end of the month by posting the totals of the Purchases and Carriage columns to the debit of those accounts in the General Ledger. Items in the Sundries column have already been posted to the General Ledger in detail (the folio column being provided for that purpose), so the total of that column does *not* have to be posted.

RETURNS OUTWARDS 1.

Date	*Name*	*Fo.*	*Amount*	*Purchases*	*Carriage*	*Sundries*		
19—								
Jan. 3	W. Archer, Ltd.	5	20 0 0			Fixtures and Fittings (Allce. for old show-case)	GL 4	20 0 0
	D. Wright & Sons	2	3 2 6	3 2 6				
			£23 2 6	£3 2 6				£20 0 0
				GL 11				

Note. The ruling of this book should always be the same as the ruling of the Bought Day Book, even though in this month no

Folio 1 PETTY CASH

Receipts			*Date*	*Payments*	*Amount*
19—					
Jan. 1	J 1	10 0 0	Jan. 3	Postage stamps	1 0 0
			8	Office expenses	3 4
			10	Stationery	5 6
			17	Carriage	10 0
			21	Cooper & Co.	19 10
				Poundage on P.O.	2
			24	Cash purchases	16 11
				Office cleaning	17 6
				Milk	2 6
				Postage stamps	1 0 0
31	CB 1	5 15 9	31	Balance	10 0 0
		£15 15 9			£15 15 9
Feb. 1	b/d	10 0 0			

Note. The petty cash is kept on the imprest system, as the amount drawn from the bank on January 31 for petty cash was exactly equal to the expenditure during the month, and has the effect of restoring the balance to the original £10.

The book is provided with suitable analysis columns, including one for Sundries, which in this instance is used to record the payment to Cooper & Co. on January 21; this payment has to be posted to the personal account of that firm in the Bought Ledger.

use is made of the column headed Carriage. The Sundries column is used to record the allowance of £20 received in respect of the old show-case, this being an exceptional transaction and not a sale in the ordinary course of business.

Entries in this book are in effect the reverse or negation of entries in the Bought Day Book, and the double entry is completed accordingly.

RETURNS INWARDS 1.

19—				
Jan.	Green & Co.	Cancellation of invoice	4	62 5 0
10	R. Brown & Sons	Credit re goods stolen in transit	3	15 0 0
				£77 5 0
				GL 12

Note. The ruling of this book follows that of the Sales Day Book, of which it is the counterpart, with an additional column in which the reason for the entry is given. The double entry is completed accordingly.

BOOK *Folio* 1

Postage	*Office and Gen. Exp.*	*Stationery*	*Carriage*	*Cash Purchases*	*Sundries*	
1 0 0						
	3 4					
		5 6				
			10 0			
					BL 4	19 10
	2					
				16 11		
	17 6					
	2 6					
1 0 0						
					c/d	10 0 0
£2 0 0	£1 3 6	5 6	10 0	16 11		£10 19 10
GL 16	GL 17	GL 7	GL 15	GL 10		

Note that in order to post the correct amount to the Bought Ledger, the cost of the postal order is dealt with separately as an office expense.

Although the Petty Cash Book is a book of prime entry, it is also a ledger account in that it records the balance of petty cash in hand at any time. The balance of £10 at the end of the month is, therefore, taken into the Trial Balance on that date.

Folio 1 CASH BOOK

Date	*Particulars*	*Folio*	*Discount*	*Details*	*Bank*	*Date*
19—						19—
Jan. 1	To Balance (Cash at Bank)	J 1			432 1 1	Jan. 3
6	C. White	SL 1	3 7 8	131 19 6		
	Cash sales	GL 9		5 0 0		
					136 19	10
	Blacksmiths, Ltd.	SL 2	2 7 2	57 14 6		
	Gray Bros., Ltd.	SL 5	5 2 4	97 4 4		
					154 18	
25	Cash sales	GL 9			7 10	
						13
						17
						20
						22
						24
						31
			£10 17 2		£731 10	
			GL 13			

Note. As all money received by the trader is paid into the bank and all payments are made by cheque (or by cashing a cheque for the appropriate amount), the Cash Book is really a record of bank transactions. A three-column ruling is used as, in addition to the actual record of lodgments and withdrawals, it is necessary to provide for:

(1) Cash discounts received and allowed respectively.

(2) Details of amounts paid into and withdrawn from the bank where the lodgments or cheques drawn cover more than one item.

The Discount columns constitute part of the double-entry system of booking. The items in the *debit* Discount column are *credited* to the appropriate accounts in the Sales Ledger; the

Folio 1

Particulars	*Folio*	*Discount*	*Details*	*Bank*
By Wages	GL 6		15 0 0	
Drawings	GL 2		10 0 0	
				25 0 0
H. Smith	BL 1	6 1 3		195 19 9
D. Wright & Sons	BL 2			67 2 8
British Railways	BL 3			19 8 0
Wages	GL 6		16 10 0	
Drawings	GL 2		10 0 0	
				26 10 0
Plowman & Co.	BL 6	7 13 0		145 7 0
Wages	GL 6		15 10 0	
Drawings	GL 2		10 0 0	
				25 10 0
W. Archer, Ltd.	BL 5			77 10 0
Quill & Quarto, Ltd., stationery	GL 7			6 5 0
Wages	GL 6		16 0 0	
Drawings	GL 2		10 0 0	
				26 0 0
Wages	GL 6		17 0 0	
Drawings	GL 2		15 0 0	
Petty cash	PCB 1		5 15 9	
				37 15 9
R. Scratchett, salary	GL 8			25 0 0
Balance	c/f			54 2 1
		£13 14 3		£731 10 3
		GL 14		

double entry is therefore completed by posting the monthly total to the *debit* of Discounts Allowed Account in the General Ledger. Conversely, the monthly total of the *credit* Discount column has to be *credited* to Discounts Received Account.

On the other hand, the Details columns merely contain an analysis of some of the entries in the main Bank columns, to which they are subsidiary. The Bank columns themselves constitute a ledger account showing the balance at the bank at any time. The balance of £54 2s. 1d. at the end of the month will, therefore, have to be taken into the Trial Balance.

Before the Cash Book is balanced and ruled off, it will be necessary to reconcile the balance with that shown by the Bank Pass Book or statement.

SALES LEDGER

C. White — 1.

19— Jan. 1	To Balance	J 1	135 7 2	19— Jan. 6	By Cash	CB 1	131 19 6
2	Goods	SDB 1	97 10 0		Discount	CB 1	3 7 8
6	"	"	48 2 1	31	Balance	c/d	145 12 1
			£280 19 3				£280 19 3
Feb. 1	To Balance	b/d	145 12 1				

Blacksmiths, Ltd. — 2.

19— Jan. 1	To Balance	J 1	94 6 8	19— Jan. 20	By Cash	CB 1	57 14 6
					Discount	"	2 7 2
					Contra Account	J 1	34 5 0
			£94 6 8				£94 6 8

R. Brown & Sons — 3.

19— Jan. 3	To Goods	SDB 1	29 2 9	19— Jan. 10	By Credit	R1 B1	15 0 0
					Balance	c/d	14 2 9
			£29 2 9				£29 2 9
Feb. 1	To Balance	b/d	14 2 9				

Green & Co. — 4.

19— Jan. 5	To Goods	SDB 1	62 5 0	19— Jan. 7	By Cancellation	R1 B1	62 5 0
7	"	"	54 1 6	31	Balance	c/d	54 1 6
			£116 6 6				£116 6 6
Feb. 1	To Balance	b/d	54 1 6				

Gray Brothers, Ltd. — 5.

19— Jan. 10	To Goods	SDB 1	102 6 8	19— Jan. 20	By Cash		97 4 4
					Discount		5 2 4
			£102 6 8				£102 6 8

Note. Accounts are opened in this ledger for all firms or persons who normally buy goods on credit from the trader. Personal accounts are usually balanced monthly. Before inserting and carrying down any balance, however, the book-keeper should check the "make-up" of the balance. For example, the account of C. White, before it is balanced, appears as follows:

Jan. 1	To Balance	J 1	135 7 2	Jan. 6	By Cash	CB 1	131 19 6
2	Goods	SDB 1	97 10 0		Discount	"	3 7 8
6	"	"	48 2 1				*(135 7 2)*
			(280 19 3)				

The book-keeper inserts pencil totals (shown in italics above) immediately under the last entry on each side. He then deducts the smaller total from the larger one and calculates the balance to be £145 12s. 1d. Before inserting this and ruling off the account he sees that it represents the sum of the two invoices sent to White during the month. A monthly statement will then be prepared and sent to White, incorporating these two invoices and showing the balance due from him.

Bought Ledger

H. Smith — 1.

19— Jan. 10	To Cash	CB 1	195 19 9	19— Jan. 1	By Balance	J 1	202 1 0
	Discount		6 1 3				
			£202 1 0				£202 1 0

D. Wright & Sons — 2.

19— Jan. 3	To Allowance	ROB 1	3 2 6	19— Jan. 1	By Balance	J 1	67 2 8
10	Cash	CB 1	67 2 8	2	Goods	BDB 1	17 2 6
31	Balance	c/d	83 10 2	12	"	"	69 10 2
			£153 15 4				£153 15 4
				Feb. 1	By Balance	b/d	83 10 2

British Railways — 3.

19— Jan. 10	To Cash	CB 1	19 8 0	19— Jan. 1	By Balance	J 1	19 8 0
31	Balance	c/d	26 2 3	15	Carriage	BDB 1	26 2 3
			£45 10 3				£45 10 3
				Feb. 1	By Balance	b/d	26 2 3

Cooper & Co. — 4.

19— Jan. 21	To Petty Cash	PCB 1	19 10	19— Jan. 1	By Goods	BDB 1	19 10

W. Archer, Ltd. — 5.

19— Jan. 3	To Allce. (old show-case)	ROB 1	20 0 0	19— Jan. 3	By Fixtures and Fittings (show-case)	BDB 1	97 10 0
20	W. Archer, Ltd.	CB 1	77 10 0				
			£97 10 0				£97 10 0

Plowman & Co. — 6.

19— Jan. 13	To Cash	CB 1	145 7 0	19— Jan. 6	By Goods	BDB 1	153 0 0
	Discount	"	7 13 0				
			£153 0 0				£153 0 0

Blacksmiths, Ltd. — 7.

19— Jan. 20	To Contra A/c	J 1	34 5 0	19— Jan. 18	By Goods	BDB 1	34 5 0

Note. The opening and keeping of the Bought Ledger accounts is in the main similar to, but the reverse of, the work done in the Sales Ledger. Again the make-up of the balances should be considered before they are finally inserted and ruled off, but in this case it may also be as well to await the receipt of monthly statements from the suppliers before completing the balancing.

General (or Impersonal) Ledger

B. Abbott, Capital Account — 1.

				19— Jan. 1	By Sundries	J 1	3719 11 10

B. Abbott, Drawings — 2.

19— Jan. 3	To Cash	CB 1	10 0 0				
10	"	"	10 0 0				
17	"	"	10 0 0				
24	"	"	10 0 0				
31	"	"	15 0 0				

Freehold Premises — 3.

19— Jan. 1	To Balance	J 1	2000 0 0				

Fixtures and Fittings — 4.

19— Jan. 1	To Balance	J 1	500 0 0	19— Jan. 3	By Allce. for old show-case	ROB 1	20 0 0
3	Show-case	BDB 1	97 10 0				

Stock — 5.

19— Jan. 1	To Balance	J 1	836 7 9				

Wages — 6.

19— Jan. 3	To Cash	CB 1	15 0 0				
10	"	"	16 10 0				
17	"	"	15 10 0				
24	"	"	16 0 0				
31	"	"	17 0 0				

Stationery — 7.

19— Jan. 22	To Cash	CB 1	6 5 0				
31	Petty Cash	PCB 1	5 6				

Salaries — 8.

19— Jan. 31	To Cash	CB 1	25 0 0				

Sales — 9.

				19— Jan. 6	By Cash	CB 1	5 0 0
				25	"	CB 1	7 10 0
				31	Sundries	SDB 1	393 8 0

Purchases — 10.

19— Jan. 31	To Sundries	BDB 1	274 17 6				
	Petty Cash	PCB 1	16 11				

Returns Outwards & Credits Received — 11.

				19— Jan. 31	By Sundries	ROB 1	3 2 6

Returns Inwards & Credits Allowed — 12.

19— Jan. 31	To Sundries	RIB 1	77 5 0				

Discounts Allowed 13.

19— Jan. 31	To Sundries	CB 1	10 17 2				

Discounts Received 14.

				19— Jan. 31	By Sundries	CB 1	13 14 3

Carriage 15.

19— Jan. 31 31	To Sundries Petty Cash	BDB 1 PCB 1	26 2 3 10 0				

Postage 16.

19— Jan. 31	To Petty Cash	RCB 1	2 0 0				

Office & General Expenses 17.

19— Jan. 31	To Petty Cash	PCB 1	1 3 6				

Note. The accounts in this ledger are not balanced off in the way in which the Personal Ledgers were balanced. These accounts will not normally be balanced until the end of the last six months' trading, and even then many closing entries will have to be made.

TRIAL BALANCE

C. White	SL 1	145 12 1	
R. Brown & Sons	3	14 2 9	
Green & Co.	4	54 1 6	
D. Wright & Sons	BL 2		83 10 2
British Railways	3		26 2 3
B. Abbott, Capital Account	GL 1		3,719 11 10
B. Abbott, Drawings	2	55 0 0	
Freehold Premises	3	2,000 0 0	
Fixtures and Fittings	4	577 10 0	
Stock	5	836 7 9	
Wages	6	80 0 0	
Stationery	7	6 10 6	
Salaries	8	25 0 0	
Sales	9		405 18 0
Purchases	10	275 14 5	
Returns Outwards	11		3 2 6
Returns Inwards	12	77 5 0	
Discounts Allowed	13	10 17 2	
Discounts Received	14		13 14 3
Carriage	15	26 12 3	
Postage	16	2 0 0	
Office and General Expenses	17	1 3 6	
Cash at Bank	CB 1	54 2 1	
Petty Cash	BCB 1	10 0 0	
		£4,251 19 0	£4,251 19 0

Note. For the purpose of extracting a Trial Balance the accounts in the General Ledger will merely be totalled in pencil.

QUESTIONS AND EXERCISES

(Key to answers on page 569)

(1) Make brief answers to the following questions:
(*a*) From what source would you derive information to make up (i) the Sales Book; (ii) the Purchases Book?
(*b*) In what circumstances would a credit note be used?
(*c*) What is meant by a debit balance? (*L.C. of C. Elem.*).

(2) R. Lane is a textile merchant; his business is divided into two departments: (*a*) linen and (*b*) cotton. Give the ruling for a suitable analysed Purchases Day Book and enter therein the following invoices:

March 1 M. Ferguson: 400 yards of printed linen at 18s. per yard, less 25 per cent trade discount.
Four gross of assorted cotton lengths at £19 12s. per gross.
„ 2 B. Smith: Assorted lots—Linen £125; Cotton Goods £125.
„ 3 F. Maxwell: Four and a half gross of linen cloths at £144 per gross.
(*R.S.A. Stage I*).

(3) Fires Limited, fuel distributors, require to know the total quantities and value of the sales of each kind of fuel sold. Rule a Sales Day Book, which would enable this information to be obtained, enter the following sales and show the details required for the week ending January 10.

Jan.	5	Sold to	T. Mason 1 ton household nuts at £4 10s. 7d. per ton.
„	5	„	P. Francis 6 cwt. household nuts for £1 7s. 2d.
„	6	„	F. Longman 10 tons coke at 98s. 4d. per ton.
„	6	„	L. Lewis 2 tons anthracite at 108s. 3d. per ton.
„	7	„	M. Day 10 cwt. coke at 98s. 4d. per ton.
„	8	„	K. Hancock 2 tons household nuts at 90s. 7d. per ton.
„	8	„	D. Noad 1 ton anthracite at 108s. 3d. per ton.
„	9	„	A. Weatherley 5 cwt. coke at 98s. 4d. per ton.
„	10	„	R. Burgess 10 cwt. anthracite at 108s. 4d. per ton.

(*R.S.A. Stage II*).

(4) From the following particulars show M. Felton's Cash Book for the week ended May 12, with bank and discount columns, and showing the detail of amounts paid into bank. In entering the items name the account to which each item would be posted:

			£	s.	d.
May	6	Balance—Overdraft	56	9	0
„	7	Paid into Bank—			
		Cheques—R. Silver (discount already deducted £1 16s. 6d.)	34	13	6
		W. Ranson (discount already deducted £4 6s.)	81	4	0
„	9	Drew cheques—			
		C. Garrow (discount already deducted £1 11s. 3d.)	49	13	9
		Wilstead Gas Co., Ltd.—for gas supplied	4	9	0
„	11	Paid into Bank—			
		Cash Sales	67	3	0
		Cheques—J. Ladd	10	5	0
		F. Grow	21	8	0
		Drew cheque for private purposes	10	0	0

Balance the Cash Book at May 11.

(*L.C. of C. Elem.*).

(5) The following items, among others, appear in A. Gilpin's Cash Book:

	£	s.	d.
Debit side—			
Cash sales	10	3	4
Total of discount column	3	2	6
Credit side (bank column)—			
J. Grant	42	6	8
Eton U.D.C. for rates	13	1	9
Purchase of office typewriter	26	5	0
Bank charges	4	4	0
Refund to customer on cash sale	1	2	6

You are required to show exactly how the above transactions would appear when posted to A. Gilpin's ledger. (*L.C. of C. Elem.*).

(6) M. Beck obtains his pass book from the bank once a month. At the end of September his Cash Book showed a balance of £42 8s. overdrawn and the Bank Pass Book showed a balance of £1 19s. 3d. in hand. The difference was accounted for as follows:

(*a*) A cheque for £3 10s. paid into the bank by Beck on September 30 was not credited by the bank until October 1.

(*b*) Cheques drawn by Beck for £11 7s. 6d. in favour of Kelsey & Co. in August, and for £9 19s. 6d. in favour of Robins & Co. and £28 1s. 3d. in favour of Smith & Co. in September, had not yet been presented.

(*c*) The Bank Pass Book showed an entry on September 15 of 10s. for a cheque book, and an entry on September 30 of £1 1s. for bank charges, neither of which had been entered in the Cash Book.

Draw up a bank reconciliation statement and also a statement showing the additional entries required in the Cash Book and the correct bank balance. (*R.S.A. Stage I*).

(7) Enter the following transactions in the Petty Cash Book of Messrs. Roberts & Co., Ltd., showing the analysis under the headings of Postage, Stationery, Carriage, Travelling Expenses and Office Expenses:

Feb.	1	Received £15 for petty cash float.
„	1	Bought postage stamps for £1 12s. 6d.
„	5	Paid fares 13s. 9d.
„	6	Paid 10s. for cleaning office windows.
„	10	Paid 4s. 6d. for tea.
„	11	Paid for carriage 14s. 9d.
„	15	Bought postage stamps for £1 19s. 6d.
„	18	Paid 7s. 4d. for fares.
„	20	Paid £1 11s. 2d. for stationery.
„	23	Paid 17s. 10d. for carriage.
„	27	Bought postage stamps for £1 18s. 4d.
„	28	Paid office milk bill 7s. 5d.
Mar.	1	Received total amount of expenditure for February.

(*R.S.A. Stage II*).

(8) On April 1 the position of J. Rover's business was as follows:

Petty Cash £10; Cash at Bank £206 17s.; Stock £672.
Debtors: F. Jamison £89 3s. 4d., L. Cranstow £46 10s. 0d.
Creditors: Supplies Co., Ltd. £83 2s.; O. Merry £72 9s. 6d
Furniture and Fixtures £210.
Motor Vans £195.

(*a*) Find J. Rover's capital at April 1 and open ledger accounts to record the above position.

(*b*) Pass the following transactions through the subsidiary books, post to the ledger and extract a Trial Balance at April 5:

April 1 F. Jamison paid his account less $2\frac{1}{2}$ per cent cash discount. Sold goods to Jamison at list price £96 10s.
„ 2 Paid Supplies Co., Ltd., their account by cheque less 5 per cent cash discount, and purchased from them goods at list price £72 4s. less 25 per cent trade discount.
„ 3 Paid by cheque to C. V. Garages £10 3s. 2d. for petrol, oil and repairs to motor van.
„ 4 Paid cheque for one quarter's rent, £62, to Hall Estates, Ltd. Paid O. Merry his account as at April 1 less 5 per cent cash discount and purchased from him goods at list price £65 10s. less 20 per cent trade discount.
„ 5 Returned to Supplies Co., Ltd., goods purchased on April 2 at list price £12 16s. Paid by petty cash: Office expenses £3 5s. 6d.; and Postages £4 2s. 5d. (*L.C. of C. Elem.*).

(9) Enter the following transactions in the proper subsidiary books and make postings to the ledger.

Mar. 1 Sold on credit goods to F. Salter at catalogue price £90 less 25 per cent trade discount and 5 per cent for cash in one month.
„ 4 Purchased on credit from Office Furnishings, Ltd., new office furniture £76.
„ 7 Sold on credit goods to R. Rennie £45 less 20 per cent trade discount.
„ 10 Purchased on credit from Supplies, Ltd., stock-in-trade £142.
„ 13 F. Salter returned goods, catalogue price £12.
„ 15 Purchased on credit from M. Naseby goods for resale £62.
„ 20 Packing materials purchased on credit from Packings, Ltd., £7. (*L.C. of C. Elem.*).

(10) If the following errors had been made in the ledger, how would they affect the Trial Balance?

(*a*) £4 10s. cheque received from R. Stone had been debited in the Bank Account and also debited in Stone's Account.
(*b*) The total purchases for July were £794. This was posted to Purchases Account as £749.
(*c*) A sale to L. Turner of £31 10s. 9d. had been entered in the Sales Book and posted to the accounts as £31 9s. 10d.
(*d*) Discount received from D. Angel, £3 5s. was included in the Discount Account, but not posted to Angel's Account.

Give the effect of each error and also the total effect. (*L.C. of C. Elem.*).

(11) J. Perkins is a coal merchant. On October 1 his assets and liabilities were as follows:

Cash at bank £157 12s. 3d.; cash in hand £19 15s. 7d.; stock on hand £295 10s.; motor lorries £375.
Debtors: S. Freeman £19 5s.; Seaview Hotel £79 15s.
Creditors: Main Colliery Co. £97 10s.: Blanktown Gasworks £35 17s. 6d.; one quarter's rent £50.

Open, by journal entry, the accounts necessary to record the above in Perkins's books. Then enter in the proper books of original entry, analysing all purchases and sales as between coal and anthracite on the one hand and coke on the other, and post to the ledger the following transactions:

Oct. 2 Received from the Main Colliery Co. a credit note for £2 10s. for short weight on a consignment of anthracite received in September. Cash sales (not banked), coal £7 17s.
„ 3 Received and banked a cheque from the Seaview Hotel for £50. Bought on credit from the Blanktown Gasworks 10 tons coke nuts at £2 15s. per ton and 6 tons broken coke at £2 12s. 6d. per ton, the whole subject to 5 per cent trade discount. Sent the Main Colliery Co. a cheque to settle their account, deducting $2\frac{1}{2}$ per cent cash discount.

Oct. 4 Received from the X Garage an invoice for £550 for a new motor lorry, delivered to-day, and £35 10s. for repairs to an old lorry, £585 10s. in all. Sent the X Garage a cheque for £200 on account. Cash sales (all coke) £21 5s. banked, together with the cash sales on October 2.

„ 6 Sold to the Seaview Hotel, on credit, 5 tons of anthracite at £4 15s. per ton and 2 tons of coke at £3 12s. 6d. per ton. Cash sales (coal) £26 10s. banked. Sent the Blanktown Gasworks a cheque for £30 on account. Bought for cash, office stationery £2 15s. Sold an old motor lorry for £120, received by cheque which was banked.

„ 7 Received from S. Freeman a cheque in settlement of his account, and from the Seaview Hotel a cheque for £25, both paid to bank. Drew and cashed a cheque for £30, of which Perkins kept £15 for private expenses, paid £12 10s. in wages and paid the remaining £2 10s. into office cash.

„ 8 Bought on credit from the Main Colliery Co. 30 tons anthracite at £3 15s. per ton. Sold on credit to S. Freeman 15 cwt. of best house coal at £4 5s. per ton. The cheque for £25 received the day before from the Seaview Hotel was returned by the bank unpaid. Paid by cheque the rent due for the quarter to September 29, £50.

Balance the ledger accounts and Cash Book as on October 8, bring down the balances and extract a Trial Balance.

Note. No Trading and Profit and Loss Account or Balance Sheet is to be prepared. (*R.S.A. Stage I*).

(12) M. Martin is a coal merchant. On January 1 his position was as follows:

Cash at bank £510; Stock £805 10s. Sundry Debtors: H. Mellor £84; W. Phillips £70. Creditor: F. Franks £130 10s. Delivery Carts £150; Horses £100. Petty Cash in hand £5.

Open, by journal entry, the accounts necessary to record the above position in Martin's books and post thereto, using the proper subsidiary books, the following transactions:

(*Note.* A Petty Cash Book with two analysis columns, headed (*a*) Purchases and (*b*) Wages, is to be used for recording payments made in cash. All cheques received are paid direct to bank and the main Cash Book requires only discount and bank columns.)

Jan. 2 Drew £30 from the bank for petty cash.

„ 3 H. Mellor settled his account by a cheque, deducting 5 per cent cash discount allowable.

„ 4 Purchased, on credit, from F. Franks: 75 tons of coal at 50s. per ton; 60 tons of coke at 40s. per ton.

„ 5 Martin drew, by cheque, £20, for private expenses. Sold a delivery cart for £30 to G. Smith, who paid for it by cheque.

„ 6 Paid from petty cash: £18 19s. 10d. for coal and firewood (for resale); and wages £15. Paid by cheque the amount due to F. Franks on January 1, less 5 per cent cash discount.

„ 8 Sold, on credit, to A. Mellor: 2 tons of coal at 63s. per ton, and firewood £2. Purchased and paid for by cheque, a horse from W. Ash £45.

„ 9 Drew £20 from the bank for petty cash.

„ 10 Paid, by cheque, £4 15s. to B. Coles for repairs to a delivery cart.

„ 11 Sold, on credit, to W. Phillips: coal £30, coke £15.

„ 12 Paid from petty cash: wages £17 10s.

„ 13 Received a cheque for £75 on account from W. Phillips.

Balance the Cash Book, Petty Cash Book and ledger accounts, bring down the balances and extract a Trial Balance as on January 13. No Trading and Profit and Loss Accounts or Balance Sheet are to be prepared. (*R.S.A. Stage I*).

CHAPTER V

PRINCIPLES OF ANNUAL ACCOUNTS

THE Trial Balance produced in the comprehensive example at the end of the preceding chapter does more than prove (subject to the limitations described) the arithmetical accuracy of B. Abbott's books; it summarizes on one sheet his transactions for the month and gives particulars of his assets and liabilities at the end of that period in so far as they are recorded in his books. The balances can be considered under the following headings:

ACCOUNTS WHICH DETERMINE PROFIT OR LOSS

	Debits £ s. d.	Credits £ s. d.
Stock (value of stock on hand at the *beginning* of the period, part of which has probably been sold)	836 7 9	
Purchases (cost of further goods bought during the period)	275 14 5	
Returns Outwards (credit notes received, which have the effect of reducing the cost of goods purchased)		3 2 6
Sales (gross proceeds of sale of goods)		405 18 0
Returns Inwards (credit notes issued which have the effect of reducing the credit for sales)	77 5 0	
Wages (expenses incurred in carrying on the business)	80 0 0	
Stationery	6 10 6	
Salaries	25 0 0	
Postage	2 0 0	
Office and General Expenses	1 3 6	
Discounts Allowed	10 17 2	
Discounts Received (a credit balance which results in increased profit)		13 14 3
Carriage (in this case an addition to the cost of purchasing goods bought at prices excluding delivery to Abbott's warehouse)	26 12 3	

These accounts will not, in themselves, enable the profit for the month to be ascertained. In addition to any other adjustments that may be necessary, it is clear that the value of the stock of unsold goods on hand at January 31 must be known before the profit or loss can be calculated. The value of the *closing stock* cannot be found from the books; the trader or some other person with the necessary technical knowledge must make a detailed inventory of the goods in the warehouse. In normal

circumstances this schedule will be valued at cost price. If it be assumed that this has been done and results in a valuation of £895 4s. 2d., a statement in the following form could be prepared:

B. Abbott

(Draft) Trading and Profit and Loss Account for the month ended January 31

To Stock, Jan. 1				836	7	9	By Sales	405	18	0					
Purchases	275	14	5				*Less* Returns	77	5	0					
Less Returns	3	2	6									328	13	0	
				272	11	11	Stock, Jan. 31					895	4	2	
Carriage Inwards				26	12	3									
Gross Profit, carried down				88	5	3									
				£1,223	17	2						£1,223	17	2	
To Wages				80	0	0	By Gross Profit, brought down					88	5	3	
Salaries				25	0	0	Discounts Received					13	14	3	
Discounts Allowed				10	17	2	Balance, being Net Loss for the month					23	11	8	
Stationery				6	10	6									
Postage				2	0	0									
Office and General Expenses				1	3	6									
				£125	11	2						£125	11	2	

It will be observed that the account has been divided into two portions. The first, known as the Trading Account, is designed to show the *gross profit* on sale of goods. This is achieved by setting against the net proceeds of sale, the actual cost of the goods sold. The Trading Account could, in fact, be set out in the following way:

B. Abbott

Trading Account for the month ended January 31

To Stock, Jan. 1	836	7	9	By Sales, less Returns	328	13	0
Purchases, less Returns	272	11	11				
Carriage Inwards	26	12	3				
	1,135	11	11				
Less Stock, Jan. 31	895	4	2				
Cost of Goods Sold	240	7	9				
Gross Profit, carried down	88	5	3				
	£328	13	0		£328	13	0

Gross profit is the excess of the selling price of goods sold over their cost (before taking into account administrative and distributive expenses). Although the figure of £88 5s. 3d. has been calculated by considering all the trading transactions of the month in total, it represents the sum of all the separate gross profits earned during the month on each article sold. As Abbott is a wholesale trader, that is, as he buys goods and resells them in the same condition, all expenses incurred except carriage inwards are overhead expenses or distributive charges. They do not affect his gross profit but have to be defrayed out of it, however large or small it may be. The Profit and Loss Account shows that in this month the overhead expenses have actually exceeded the gross profit and Abbott's trading activities have therefore resulted in a net loss to him.

The overhead expenses charged in this Profit and Loss Account comprise the balances standing on all the nominal accounts in the General Ledger, other than those already dealt with in the Trading Account. To obtain a true picture of the profit or loss for the month it is possible that some of these items will require to be adjusted and some additional debits may have to be made which do not at present appear in the books. For the time being it will be assumed that no such adjustments arise. The remaining items in the Trial Balance can then be described as:

ACCOUNTS WHICH DETERMINE THE TRADER'S FINANCIAL POSITION AT THE END OF THE PERIOD

		Debits			*Credits*		
		£	s.	d.	£	s.	d.
C. White	These balances, totaling £213 16s. 4d., may collectively be described as Sundry Debtors, being amounts owing to the trader by his customers	145	12	1			
R. Brown & Sons		14	2	9			
Green & Co.		54	1	6			
D. Wright & Sons	Conversely, these balances, totalling £109 12s. 5d., constitute Sundry Creditors				83	10	2
British Railways					26	2	3
Freehold Premises	These balances represent fixed assets, that is, assets held for continued use in the business and not for resale or conversion into cash. They may, however, be subject to depreciation, for which provision will have to be made	2,000	0	0			
Fixtures and Fittings		577	10	0			

BALANCE SHEET

		£ s. d.	£ s. d.
Cash at Bank	These items are floating or current assets, as also are Sundry Debtors, considered above, and the next item, Stock in Hand	54 2 1	
Petty Cash		10 0 0	
Stock in Hand	This item, although not yet a balance in the books or in the Trial Balance, will have to be taken into account here just as it was taken into account in the Trading Account	895 4 2	
		3,750 12 7	109 12 5
		109 12 5	
Showing an excess of assets over liabilities of		£3,641 0 2	

Which is represented by:		
B. Abbott, Capital Account (Balance on Jan. 1)		3,719 11 10
B. Abbott, Drawings Account	55 0 0	
Net loss disclosed by Profit and Loss Account	23 11 8	
		78 11 8
		£3,641 0 2

A statement in the form of an account, summarizing all the balances remaining in a set of books other than those which comprise the Trading and Profit and Loss Account, is known as a Balance Sheet. It is generally presented in the following form:

B. ABBOTT

Balance Sheet as at January 31

B. Abbott, Capital Account:				Freehold Premises	2,000 0 0
Balance at Jan. 1		3,719 11 10		Fixtures and Fittings	577 10 0
Less Net loss for the month ended Jan. 31	23 11 8			Stock-in-Trade	895 4 2
Drawings	55 0 0			Sundry Debtors	213 16 4
		78 11 8		Cash at Bank	54 2 1
			3,641 0 2	Cash in Hand	10 0 0
Sundry Creditors			109 12 5		
			£3,750 12 7		£3,750 12 7

It will be observed that:

(1) The accounts which showed debit balances on the Trial Balance appear on the assets side of the Balance Sheet, and vice versa. There is an historical reason for this and as the Balance Sheet is a statement and not a ledger account, there is no inconsistency in following this practice.

(2) The prime function of the Balance Sheet is to show how the trader's capital at the end of the period is represented by the total of his assets, less his liabilities.

(3) The assets are shown on the Balance Sheet in a logical sequence, which in this case can be described as the inverse order of realizability. In other words, the most permanent asset, freehold premises, comes first, while the most liquid asset, cash in hand, comes last. Some authorities prefer to adopt the reverse order; what is important is that a logical sequence should be followed.

(4) In the case of the fixed assets, the sequence is determined by the relative permanency of the items, freehold premises clearly being of a more permanent nature than fixtures and fittings.

(5) The order of realizability of the floating assets is fixed by the natural sequence of the trading transactions. Stock sold to a customer is converted into a book debt. When the customer pays his account the book debt is converted into cash at bank. The cash in hand (petty cash) balance was in turn a sum of money withdrawn from the bank.

(6) Balances from the books which are of the same nature, such as the Sales Ledger balances and Bought Ledger balances, are not shown in detail but under the descriptive headings Sundry Debtors and Sundry Creditors. It would be no more reasonable to show them in detail than it would be to show the constituent items of Stock-in-Trade. A Balance Sheet should contain as much detailed information as is necessary to disclose the financial position of the trader. If too many details are given, they tend to obscure the essential facts which the Balance Sheet is intended to present.

(7) The entries under the heading B. Abbott, Capital Account, show how the trader's capital has, in this case, been reduced during the period because: (*a*) his trading resulted in a net loss of £23 11s. 8d.; and (*b*) he withdrew £55 for his own personal use. Had a net profit been made it would have increased his opening capital and would have been added to the opening balance. Similarly, if he had introduced any additional capital during January that also would have increased the balance on Capital Account.

(8) This Balance Sheet and the Trading and Profit and Loss Account which preceded it have (for the sake of simplicity) been drafted entirely from the figures appearing in the Trial Balance, except that the value of the closing stock has been taken into account.

The net profit and the trader's financial position at the end of the period would have been shown more accurately if certain adjustments had been made.

The Trading Account, Profit and Loss Account, and Balance Sheet, known collectively as the final accounts of a business, are normally prepared once a year. They can, of course, be prepared at monthly or other intervals, but such accounts are not as a rule incorporated in the books and are then known as interim accounts. The preparation of the final accounts, however, is part of the process of double-entry book-keeping. The nominal accounts are closed by transferring amounts from them to the Trading and Profit and Loss Accounts. The Balance Sheet then summarizes all the balances remaining in the books (which is why it is called a *Balance* Sheet).

In order to illustrate the principles involved in closing a set of books, the example embracing B. Abbott's transactions for the month of January will be used, but it must be borne in mind that in practice these closing entries would not arise until the end of the year (or possibly half-year). Before the books are balanced, the following adjustments are to be made:

(1) Because Abbott owns the freehold premises, no charge appears in his Profit and Loss Account for rent, since none is payable. Nevertheless, the premises will not last for ever and it is therefore desirable that something should regularly be written off the cost of the premises. This amount will be known as Depreciation. The reasons for writing off depreciation of fixed assets and the various methods of doing so are considered in Chapter VI. At this stage let it be assumed that depreciation at the rate of 3 per cent per annum on £2,000, which is equivalent to £60 for a full year or £5 for one month, is to be written off.

(2) Similarly, £10 is to be written off the item Fixtures and Fittings.

(3) Fixed assets stand in the books at their original cost less depreciation written off to date, and this value is known as their written-down value. When the new show-case was bought from W. Archer, Ltd., on January 3 at a cost of £97 10s., the sum of £20 was allowed for the value of an old show-case given in part exchange. If this old show-case was included in the valuation of fixtures and fittings on January 1 at £35 (being part of the total of £500—see opening journal entry on page 60) there is a loss on sale of £35 less £20 equals £15, which must also be written off.

The ledger accounts for Freehold Premises and Fixtures and Fittings will give effect to these adjustments in the following way:

FREEHOLD PREMISES

19—						19—				
Jan. 1	To Balance	J 1	2,000	0	0	Jan. 31	By Profit and Loss A/c:			
							Depreciation	5	0	0
							Balance c/d	1,995	0	0
			£2,000	0	0			£2,000	0	0
Feb. 1	To Balance	b/d	1,995	0	0					

FIXTURES AND FITTINGS

Date		Particulars	Fo.	Amount	Date		Particulars	Fo.	Amount
19—					19—				
Jan.	1	To Balance	J 1	500 0 0	Jan.	3	By Allce. for old show-case	ROB 1	20 0 0
	3	Show-case	BDB 1	97 10 0		31	Profit and Loss A/c: Depreciation		10 0 0
							Loss on sale		15 0 0
							Balance	c/d	552 10 0
				£597 10 0					£597 10 0
Feb.	1	To Balance	b/d	552 10 0					

In strict theory the transfers to Profit and Loss Account should be recorded in the journal and the Profit and Loss Account is then written into the General Ledger as an acccunt. In practice, closing entries are frequently made by direct entry in the ledger, and the Profit and Loss Account (which is of a confidential nature) may not always be written up in the books, but may be written or typed on a separate sheet of paper. Amounts written off for depreciation may also be transferred from the asset accounts to a Depreciation Account, from which they are transferred in total to Profit and Loss Account.

(4) On January 10 a credit note for £15 was issued to R. Brown & Sons in respect of goods stolen in transit. If this loss is covered by insurance the amount recoverable from the insurance company should be brought into account as an asset, although it has not yet been received. The relative entry should not be made in Insurance Account (which in any event does not yet appear in these books) but in an account in the name of the insurance company. It will appear as follows:

XY INSURANCE CO., LTD.

Date		Particulars	Amount	
19—				
Jan.	31	To Trading A/c: Claim in respect of goods stolen in transit to R. Brown & Sons	15 0 0	

The transfer to Trading Account will increase the gross profit by £15 and reduce the net loss by the like sum. The resulting debit balance will be brought into the Balance Sheet.

(5) The debit entries in the draft Profit and Loss Account represent expenses which happen to have been paid during the month. Other expenses may have been incurred, but because they have not yet been paid and are not recorded as liabilities in the Bought Ledger they do not as yet appear in the books. Let it be assumed that in addition to the freehold premises which Abbott owns he occupies a

yard which he rents for £60 a year, payable quarterly in arrear on the usual quarter days (March 25, June 24, September 29 and December 25).

Although on January 31 no rent is due for payment, there is said to be an accrued liability for one month's rent, which must be brought into account if the Profit and Loss Account is to exhibit a true record of the expenses incurred during the month. This is effected by creating a credit balance on Rent Account:

RENT

		19—		
		Jan. 31	By Profit and Loss A/c: Provision for accrued rent	5 0 0

The effect of this adjustment is to increase the net loss by £5, the resulting credit balance being brought into the Balance Sheet as a liability.

(6) Although credit has now been taken for an insurance claim, no charge appears in the Profit and Loss Account for premiums on insurance policies. Possibly Abbott had effected insurances during the preceding year which were still current during the month of January. Let it be assumed that he paid premiums amounting to £24 on July 1 in the preceding year covering fire, burglary and loss-in-transit policies for the year commencing on that date. Then, on January 1, when the opening entry for Abbott's new set of books was made, it can be said that there was a payment in advance (that is, a proportion of insurance premiums unexpired) of £12 and this ought to have been taken into account as an asset, increasing his capital by that amount.

On January 31 the proportion of the premiums paid in advance is reduced to five-twelfths of £24, or £10. This, likewise, will be carried forward as an asset at the end of the month, the difference of £2 between the opening and closing balances on Insurance Account being transferred to Profit and Loss Account, where it represents the proportionate charge for insurance premiums for one month. Insurance Account will then appear as follows:

INSURANCE

19—				19—		
Jan. 1	To Balance (Premiums paid in advance for year ending June 30, 19—)	J 1	12 0 0	Jan. 31	By Profit and Loss A/c	2 0 0
					Balance c/d (Payment in advance)	10 0 0
			£12 0 0			£12 0 0
Feb. 1	To Balance	c/d	10 0 0			

(7) Similar adjustments for accrued expenses and payments in advance may arise in respect of many other items of expenditure. For the sake of simplicity it will be assumed that no others arise in this example. This subject is considered more fully in Chapter VII.

(8) The trader may suggest that as he has invested a substantial amount of capital in his business (and particularly as he owns freehold premises, which he therefore occupies rent free), provision should be made in his accounts for a reasonable rate of interest on his capital. His net profit will then be the excess of the net trading profit over this charge for interest, or if, as in this example, his trading has resulted in a loss, the addition of interest on capital to that loss will enable it to be seen in its true perspective.

This argument can be accepted with certain qualifications. There is no rule of law or practice which says that such a charge for interest ought to be made. It is a matter for the trader to decide for himself, and he alone can decide what rate of interest would, having regard to the nature of the business and the risk involved, be reasonable. If he decides to make the charge at, say, 5 per cent per annum, then this must be regarded as an appropriation of profit; in other words, out of the balance of net profit (or loss) shown by the Profit and Loss Account the trader appropriates so much to interest on his capital and then shows a reduced balance of profit (or, as in this case, an increased loss) to be transferred to his Capital Account.

As the interest on capital also has to be transferred to Capital Account, since it becomes part of the total balance due to the proprietor, the final result, so far as the Balance Sheet is concerned, is the same as if no provision had been made for interest.

The net trading profit or loss is not affected by this adjustment, which should be made in a separate section of the Profit and Loss Account known as the Appropriation Account.

On the assumption that the interest is to be calculated on the opening balance on Capital Account, the amounts withdrawn during the month being ignored, the appropriate amount is found as follows:

	£	s.	d.
Balance of Capital Account on January 1 as originally computed	3,719	11	10
Add Adjustment in respect of insurance premiums paid in advance	12	0	0
Corrected balance of Capital Account on January 1	£3,731	11	10

Interest at 5 per cent per annum on £3,731 11s. 10d. for one month (working in months)

$$\frac{5}{100} \times \frac{1}{12} \times 3731{\cdot}592 = £15\ 10s.\ 11d.$$

This will be recorded in an Interest on Capital Account as follows:

Interest on Capital

19—						19—					
Jan. 31	To B. Abbott, Capital A/c (5 per cent p.a. on £3,731 11s. 10d. for 1 month)		£15	10	11	Jan. 31	By Appropriation A/c		£15	10	11

(9) In order to complete the closing of the books, the remaining accounts in the General Ledger, other than those already considered, will be dealt with as follows:

(*a*) The opening value of stock will be transferred from Stock Account to Trading Account and the closing value will then be brought into account as follows:

Stock

19—						19—					
Jan. 1	To Balance	J 1	836	7	9	Jan. 31	By Trading A/c		836	7	9
31	Trading A/c		895	4	2		Balance c/d		895	4	2
			£1,731	11	11				£1,731	11	11
Feb. 1	To Balance	b/d	895	4	2						

(*b*) Those nominal accounts which do not involve any closing entry for payments in advance or accruals will be closed by transfer to Trading or Profit and Loss Account as the case may be. For example:

Salaries

19—						19—					
Jan. 31	To Cash	CB 1	£25	0	0	Jan. 31	By Profit and Loss A/c		£25	0	0

Discounts Received

19—						19—					
Jan. 31	To Profit and Loss A/c		£13	14	3	Jan. 31	By Sundries	CB 1	£13	14	3

Discounts received and discounts allowed are sometimes recorded in the same Discount Account, the net balance of which is then transferred either to the credit or to the debit of Profit and Loss Account, as the case may be. Alternatively, both sets of discount can be recorded in one Discount Account but separate transfers can be made to Profit and Loss Account, thus:

Discounts

19—				19—				
Jan. 31	To Sundries	CB 1	10 17 2	Jan. 31	By Sundries	CB 1	13 14 3
	Profit and Loss A/c		13 14 3		Profit and Loss A/c		10 17 2
			£24 11 5				£24 11 5

When making closing entries such as the above, the name Profit and Loss Account is frequently abbreviated to P. & L. A/c.

(*c*) Drawings Account will be closed by transferring the balance of it to the debit of Capital Account.

RE-DRAFTED TRADING AND PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Although the original Trial Balance on page 69 is still the starting point from which the final accounts are prepared, many adjustments or closing entries have been made, even in this simplified example. In practice, it is generally necessary to draft the final accounts before the General Ledger is closed off, and in order to ensure that none of the adjustments is overlooked, they are preferably recorded in journal form even though they are not necessarily incorporated in the books as journal entries. This schedule then constitutes an extension of the original Trial Balance and with it gives the accountant all the information necessary to complete the drafting of the accounts. The result is as follows:

Adjustments Subsequent to Trial Balance
(or Closing Journal Entries)

19—				
Jan. 1	Insurance Dr. To B. Abbott, Capital Account Correction of opening journal entry re insurance paid in advance		12 0 0	12 0 0
31	Depreciation (P. & L. A/c) Dr. To Freehold Premises Fixtures and Fittings Depreciation for month written off		15 0 0	5 0 0 10 0 0
31	Loss on Sale of Equipment (P. & L. A/c) Dr. To Fixtures and Fittings Loss on sale of old show-case written off		15 0 0	15 0 0
31	Insurance Claim Dr. To Trading A/c Outstanding claim re loss in transit		15 0 0	15 0 0
31	Rent (P. & L. A/c) Dr. To Outstanding Expenses Rent accrued for 1 month		5 0 0	5 0 0

Jan. 31	Payment in Advance To Insurance (P. & L. A/c) Insurance paid in advance for 5 months	Dr.	10 0 0	10 0 0
31	Interest on Capital (Appropriation A/c) To B. Abbott, Capital A/c Interest on capital £3,731 11s. 10d. at 5 per cent per annum for 1 month	Dr.	15 10 11	15 10 11

The Trading and Profit and Loss Accounts and Balance Sheet can now be redrafted.

B. Abbott

Trading and Profit and Loss Account for the month ended January 31

To Stock, Jan. 1		836 7 9	By Sales	405 18 0	
Purchases	275 14 5		*Less* Returns	77 5 0	
Less Returns	3 2 6				328 13 0
		272 11 11	Insurance Claim		15 0 0
Carriage Inwards		26 12 3	Stock, Jan. 31		895 4 2
Gross Profit c/d		103 5 3			
		£1,238 17 2			£1,238 17 2
To Wages		80 0 0	By Gross Profit b/d		103 5 3
Salaries		25 0 0	Discounts Received		13 14 3
Discounts Allowed		10 17 2	Net Trading Loss c/d		45 11 8
Stationery		6 10 6			
Postage		2 0 0			
Insurance		2 0 0			
Rent of Yard		5 0 0			
Office and General Expenses		1 3 6			
Loss on Sale of Show-case		15 0 0			
Depreciation:					
Freehold Premises	5 0 0				
Fixtures and Fittings	10 0 0				
		15 0 0			
		£162 11 2			£162 11 2
To Net Trading Loss b/d		45 11 8	By Balance transferred to Capital Account		61 2 7
Interest on Capital		15 10 11			
		£61 2 7			£61 2 7

B. Abbott

Balance Sheet as at January 31

B. Abbott, Capital Account:				Freehold Premises		2,000 0 0	
Balance at Jan. 1		3,731 11 10		*Less* Depreciation		5 0 0	
Add Interest on Capital		15 10 11					1,995 0 0
				Fixtures and Fittings:			
		3,747 2 9		As at Jan. 1		500 0 0	
Less Loss for month ended Jan. 31	61 2 7			Additions		97 10 0	
						597 10 0	
Drawings	55 0 0			*Less* Sale	20 0 0		
		116 2 7		Loss on Sale	15 0 0		
			3,631 0 2	Depreciation	10 0 0		
Sundry Creditors:						45 0 0	
Trade		109 12 5					552 10 0
Accrued Expenses		5 0 0		Stock-in-Trade			895 4 2
			114 12 5	Sundry Debtors:			
				Trade		213 16 4	
				Insurance claim		15 0 0	
							228 16 4
				Payment in Advance			10 0 0
				Cash at Bank			54 2 1
				Cash in Hand			10 0 0
			£3,745 12 7				£3,745 12 7

It will be observed that the Balance Sheet follows the principle laid down in the original draft in that the assets are shown in a logical sequence. In addition, the closing values of the fixed assets are reconciled with their opening values by showing the amounts written off for depreciation and loss on sale, purchases of new fixed assets and the sale of old ones. While it is not essential that this detailed information should be given, the true function of the Balance Sheet being to summarize the closing balances in the books, it is considered good practice to do so. Further improvements in the setting out of a Balance Sheet and alternative methods of doing so are considered at a later stage.

QUESTIONS AND EXERCISES

(Key to answers on page 569).

(1) What is a Trial Balance? What part does it play in the preparation of the final accounts?

(2) What is a Balance Sheet and how does it differ from a Trial Balance? Is a Balance Sheet an account?

(3) In what sequence do assets usually appear in the Balance Sheet? Distinguish between fixed and floating assets; why is the distinction important?

(4) What are closing entries? What are accrued and prepaid expenses and how are they dealt with in the final accounts?

(5) What are the arguments for and against providing for interest on capital before calculating the net profit of a sole trader?

(6) From the following list of balances you are required to prepare (*a*) a Trial Balance; (*b*) Trading and Profit and Loss Account for the year ended September 30, 1949, and (*c*) a Balance Sheet as at that date.

	£		£
Roger Coates, Capital A/c	3,500	Sundry Creditors	193
Roger Coates, Drawings A/c (drawings during the year)	265	Furniture, Fittings and Equipment	517
Stock-in-Trade, Oct. 1, 1948	432	Rent, Rates and Taxes	262
Sales	3,516	Carriage on Purchases	36
Wages	826	Motor Vans	875
Salaries	125	Cash at Bank	1,334
Purchases	1,893	Cash in Hand	43
Sundry Debtors	372	Sundry General Expenses	229

The Stock at September 30, 1949, was valued at £517. (*L.C. of C. Elem.*).

(7) The following particulars relate to certain accounts in J. Silstone's ledger. From the information given show how each account would appear after closing the accounts on March 31:

	£	s.	d.
Capital Account:			
Credit Balance, January 1	798	7	0
Net Profit for quarter to March 31	237	9	8
Drawings for quarter to March 31	200	0	0
R. Gilman's Account:			
Debit Balance, March 1	89	10	0
Sales to Gilman for month—March 10	62	9	6
March 27	43	4	7
Cheque received from Gilman—March 7	85	0	6
Discount allowed to Gilman—March 7	4	9	6
Stock Account:			
Stock in hand, January 1	232	10	0
Stock in hand, March 31	209	7	0
Furniture and Fittings Account:			
Debit Balance, January 1	210	0	0
Additional fittings purchased for cash, February 10	49	0	0
Depreciation of Furniture and Fittings, March 31	21	0	0

(*L.C. of C. Elem.*).

(8) The books of Michael Barnet showed the following balances at December 31, 1949:

	£		£
Michael Barnet, Capital	6,695	Printing and Stationery	158
Sales	9,145	Cash at Bank	701
Drawings	1,000	Cash in Hand	46
Stock at December 31, 1948	875	Discounts Received	248
Returns Inwards	275	Fixtures and Fittings	1,500
Purchases	4,786	Office Salaries	565
Wages	2,346	Bad Debts written off	227
Loan Account (credit balance)	1,000	Interest paid on Loan	50
Returns Outwards	687	Carriage Inwards	456
Advertising	400	Sundry Debtors	1,610
Plant and Machinery	3,147	Sundry Creditors	744
Carriage Outwards	70		

Rent, Rates and Insurance; this balance was inadvertently omitted; you will need to find it. The Stock at December 31, 1949, was valued at £680.

Prepare from these balances a Trial Balance in proper form. Then, by setting out part only of the Trading Account, show how you arrive at *the actual cost of the goods sold during the year*. The selling price of the goods sold is shown above at £9,145, less returns £275. You are, however, required to show what those goods *cost*, and also the rate of earning shown by the gross profit.

(*Inst. of Bkprs. Inter.*).

(9) L. Radford has an electrical and radio business. From the following particulars prepare accounts showing his gross and net profits for the half-year ended June 30:

	£	s.	d.
Sales	505	7	0
Purchases	347	5	0
Stock, January 1	121	19	0
Stock, June 30	119	14	0
Revenue from electrical and radio work executed	751	13	0
Wages of mechanic	169	0	0
Wages of shop and office assistant	104	0	0
Motor van expenses	46	3	0
Lighting and Heating (workshop)	3	1	0
Lighting and Heating (shop and office)	6	2	0
Rent and Rates (workshop)	60	4	0
Rent and Rates (shop and office)	120	8	0
Sundry Workshop Expenses	4	6	0
Sundry Shop and Office Expenses	16	7	0
Postages and Telephone	21	4	0

(*L.C. of C. Elem.*).

(10) The following Trial Balance was extracted from the books of M. Martin on June 30, 1949:

	£	£
Capital, July 1, 1948		3,450
Sundry Debtors and Creditors	3,079	2,827
Profit for the year to June 30, 1949		645
Freehold Premises	2,500	
Stock	1,290	
Drawings during the year	480	
Bank overdraft		777
Loan from H. Grayson		500
Fixtures and Fittings	850	
	£8,199	£8,199

You are required:

(*a*) To draw up M. Martin's Balance Sheet as on June 30, 1949, and

(*b*) To prepare a Balance Sheet as on July 1, 1949, as it would appear after the following transaction had taken place on that day:

£3,350 received, and paid to bank, for the sale of all the fixed assets.

(*R.S.A. Stage I*).

(11) L. Crosley runs his business in two departments (Dept. A and Dept. B). Prepare his Trading Account for year ended March 31, 1950, in columnar form so as to show the gross profit for each department and the total gross profit.

		£	s.	d.
Stock, April 1, 1949	A	27,317	10	0
	B	6,428	5	0
Purchases	A	54,068	0	0
	B	25,732	0	0
Sales	A	76,480	10	0
	B	34,812	15	0
Sales Returns	A	481	5	0
	B	86	7	0
Carriage Inwards		266	0	0
Stock, March 31, 1950	A	25,226	5	0
	B	7,072	0	0

Carriage Inwards is to be apportioned between the departments in proportion to purchases. (*L.C. of C. Certificate*).

CHAPTER VI

DEPRECIATION AND VALUATION OF ASSETS

DEPRECIATION may be defined as the reduction in value of a fixed asset occasioned either by physical wear and tear, obsolescence or the passage of time. It has been seen that most of the assets employed in a business can be divided into two main classes:

Fixed assets are those which are acquired or produced for the purpose of being used in the carrying on of the business otherwise than by being resold as part of the normal stock or output of the business (for example, plant and machinery, buildings, fittings).

Floating assets are those which are acquired or produced for the purpose of resale or which arise in the process of selling goods (for example, stock-in-trade, sundry debtors, cash balances).

This definition of a fixed asset makes it clear that such an asset is not necessarily of a permanent nature. The permanence of a fixed asset varies according to its nature, and in some cases (such as motor vehicles) may be of comparatively short duration. Further, although a fixed asset is never purchased with the intention that it will be resold, circumstances such as a change in the method of production may arise which will make it desirable to sell it before the expiration of its useful life as originally estimated. The controlling factor in deciding whether any asset is to be regarded as a fixed or floating asset is therefore the intention with which it was originally acquired. It will be noted that whereas fixed assets retain their original form for comparatively long periods, floating assets are continually being "turned over" or converted from one form into another (for example, stock into debtors, debtors into cash).

PRINCIPLES OF DEPRECIATION

When a trader acquires a new fixed asset for use in his business, he will normally take into account not only the capital outlay but also the probable time during which it will be profitable to use it. He knows that at the end of this period he will have to acquire a new fixed asset in replacement if he is to carry on the business as before.

In other words, although the acquisition of the asset is a capital transaction and it would not be reasonable to charge the whole of its cost as an expense incurred in the year in which it is purchased, he recognizes that this expenditure will have little or no residual value at the end of a certain term of years; and if he is to maintain his business in a solvent condition he must recoup this expenditure out of profits over that period. He does this by making an annual charge for depreciation of the asset concerned.

The effect of making a charge for depreciation is to reduce the amount

of profit that the trader would otherwise have been able to withdraw from the business as a reward for the use of his capital and own labour. It follows that if provision for depreciation has been made on an adequate scale so as to write off the asset over its useful life, there will eventually be available sufficient funds to enable a new asset to be purchased.

The object of providing for depreciation of an asset is thus seen to be twofold:

(1) It spreads the original cost of the asset over its useful life, enabling the trading profits to be seen in their true perspective (depreciation of fixed assets being one of the costs incurred in carrying on the business).

(2) It provides the means whereby the replacement of the asset at some future date can be ensured. (If, owing to a rise in the general price level, the ultimate cost of replacement is greater than the original cost of the old asset this statement is only partially true, and the normal methods of providing for depreciation merely ensure that the capital originally invested in the old asset is maintained intact; the additional cost of replacing the asset will represent further capital expenditure.)

The way in which this two-fold object is to be achieved will depend to a certain extent on the nature of the asset which is to be depreciated. Very many different methods have been evolved of which the most important are:

(1) the fixed instalment method;
(2) the reducing balance method;
(3) the sinking fund method; and
(4) periodical revaluation.

FIXED INSTALMENT METHOD

leasehold properties

If the main purpose of writing off depreciation is regarded as the spreading of its cost over its useful life, the simplest and most logical method would appear to be to divide the original cost by the estimated useful life and to regard the resulting quotient as the amount to be written off each year. For example, if a motor lorry is acquired at a cost of £800 and its useful life is expected to be four years, it would seem reasonable to write off £200 a year, which is equivalent to a rate of 25 per cent on the original cost.

The problem is not always as simple as this, however, and the following factors may have to be considered.

(1) *Cost.* This in most cases can be calculated easily and accurately, being the amount actually paid for the asset. In some cases (such as freehold or leasehold premises) legal and similar expenses incurred in connexion with its acquisition are correctly regarded as part of the cost; it would be neither reasonable nor correct to charge them in full in the Profit and Loss Account for the year of purchase. By capitalizing them (that is to say, debiting their cost to a fixed asset account) in the first place, they can subsequently be charged against profits over the whole life of the asset as part of the depre-

ciation charge. Similarly, if new plant is installed by the trader's own workmen, their wages whilst engaged on the work of installation should be regarded as part of the cost of the plant and therefore charged to capital (Plant Account) instead of to revenue (Trading Account).

(2) *Useful life*. In the great majority of cases this is necessarily an estimated term of years. Leasehold premises afford an exception to this rule; the date of expiration of the lease is known exactly. Other assets do not as a rule cease to be useful at any particular date; it is more probable that they will reach a point at which it is no longer profitable or economical to use them.

The factor of obsolescence also enters into the useful working life of an asset of this type. Within a relatively short time of buying a machine, new types may be available to do the same work much more efficiently and at lower cost; in fact, the whole nature of the business carried on may alter with the march of time. A machine may therefore become obsolete long before the expiration of its useful life as originally estimated.

(3) *Residual value*. It is not always necessary to write off the whole of the original cost over the expected life. If it is expected that the asset will have a residual value at the end of that period, the amount to be written off is the difference between original cost and expected residual value. For example, if it is expected that the lorry which was purchased for £800 will be sold (perhaps in part exchange for a new one) for £100 at the end of four years, then the amount to be written off each year under the fixed instalment method is

$$\frac{£800 - £100}{4} = \frac{£700}{4} = £175.$$

(4) *Additions*. The use of the fixed instalment system involves separate calculations of depreciation for each asset, since not all items of the same general type will have the same estimated useful life or the same (proportionate) residual value. Complications also arise when a new asset is bought or an old one is sold or scrapped and therefore has to be written out of the account, as in the following example.

Example

Universal Manufacturers, Ltd., started business on January 1 with plant and machinery which cost £12,000. On June 30 in the following year it purchased additional machinery at a cost of £2,000. On the following March 31 one of the original machines which had cost £500 was found to have become obsolete and was sold as scrap for £50. It was replaced on that date by a new machine costing £800. Depreciation is to be provided at the rate of 10 per cent per annum on original cost and the necessary records for the first three years are to be shown in the form of ledger accounts.

Method (1)—*Depreciation written off in Plant Account*

PLANT AND MACHINERY

Date		£	Date			£
19—		£	19—			£
Jan. 1	To Sundries	12,000	Dec. 31	By Depreciation (10 per cent on £12,000)		1,200
				Balance c/d		10,800
		£12,000				£12,000
Jan. 1	To Balance b/d	10,800	Dec. 31	By Depreciation: (10 per cent on £12,000 for one year)	1,200	
June 30	Sundries	2,000		10 per cent per annum on £2,000 for six months	100	
						1,300
				Balance c/d		11,500
		£12,800				£12,800
Jan. 1	To Balance b/d	11,500	Mar. 31	By Sundries		50
Mar. 31	Sundries	800	Dec. 31	Loss on Sale:		
				Original cost	500	
				Depreciation for $2\frac{1}{4}$ years at 10 per cent per annum	112	
				Written-down value	388	
				Proceeds of sale	50	
						338
				Depreciation:		
				10 per cent on £14,000 − £500 = £13,500 for one year	1,350	
				10 per cent per annum on £500 for three months	12	
				10 per cent on £800 for nine months	60	
						1,422
				Balance c/d		10,490
		£12,300				£12,300
Jan. 1	To Balance b/d	10,490				

It will be noted that the calculations of depreciation become more complicated each year. If these calculations are made independently of the ledger account in a detailed Plant Register, the book-keeping is simplified. A Plant Register can in fact contain much useful information besides the detailed record of depreciation charges and is a necessity in any well-run engineering concern. The information recorded will help

the management to assess the true running costs of each machine and will be of considerable assistance in deciding at what point to scrap a machine and instal a replacement.

Method (2)—*Depreciation accumulated in a separate account*

PLANT AND MACHINERY

19—			£	19—			£
Jan. 1	To Sundries		12,000	Dec. 31	By Balance	c/d	12,000
Jan. 1	To Balance	b/d	12,000	Dec. 31	By Balance	c/d	14,000
June 30	Sundries		2,000				
			£14,000				£14,000
Jan. 1	To Balance	c/d	14,000	Mar. 31	By Obsolete Machinery A/c		500
Mar. 31	Sundries		800	Dec. 31	Balance	c/d	14,300
			£14,800				£14,800
Jan. 1	To Balance	b/d	14,300				

DEPRECIATION ON PLANT AND MACHINERY

19—			£	19—			£
Dec. 31	To Balance	c/d	1,200	Dec. 31	By Profit and Loss A/c		1,200
Dec. 31	To Balance	c/d	2,500	Jan. 1	By Balance	b/d	1,200
				Dec. 31	Profit and Loss A/c		1,300
			£2,500				£2,500
Dec. 31	To Obsolete Machinery A/c		112	Jan. 1	By Balance	b/d	2,500
	Balance	c/d	3,810	Dec. 31	Profit and Loss A/c		1,422
			£3,922				£3,922
				Jan. 1	By Balance	b/d	3,810

OBSOLETE MACHINERY

19—		£	19—		£
Mar. 31	To Plant and Machinery	500	Mar. 31	By Sundries	50
			Dec. 31	Depreciation A/c	112
				Profit and Loss A/c (Loss on Sale)	338
		£500			£500

Method (2) is to be preferred to Method (1) because it enables the Balance Sheets of the concern to be drawn up in accordance with the best modern practice, which requires the original cost of the fixed assets and the total provision for depreciation to date to be shown each year. Thus,

if Method (1) is followed the Balance Sheet at the end of the third year will show Plant and Machinery as follows:

Plant and Machinery, as at January 1, at cost less depreciation		£ 11,500
Add Additions at cost		800
	£	12,300
Less Sale	50	
Loss on sale, written off	338	
Depreciation written off during year	1,422	
		1,810
		£10,490

Whereas under Method (2) the following entries will appear:

Plant and Machinery, at cost	14,300
Less Depreciation written off to date	3,810
	£10,490

2. REDUCING BALANCE METHOD

Although this method departs from the true principles of depreciation, in that it does not spread the cost of a fixed asset evenly over its useful life, it has the advantage of simplicity. The amount to be written off annually is expressed as a percentage of the written-down value of the asset at the beginning of the financial year. The amount actually written off, therefore, falls yearly as the balance on which the percentage is calculated is reduced.

It follows that the balance of the asset account is never written off entirely, but by choosing a suitable percentage rate of depreciation it can be written down to a comparatively small figure in a certain number of years. For example, a rate of 10 per cent will reduce the written-down value of an asset which cost £1,000 to £348 13s. 7d. at the end of ten years. To have achieved approximately the same result by the application of the fixed instalment system would have involved the writing off of 6½ per cent per annum on original cost.

The reducing balance method involves a disproportionately heavy charge for depreciation in the early years, which is balanced by lower charges later. It is sometimes argued that this is an advantage where assets such as plant and machinery or motor vehicles are involved, as annual maintenance and repair cost is likely to increase as the equipment gets older; the total annual debit to Profit and Loss Account for depreciation and maintenance may, therefore, tend to be averaged out.

In practice, it is unlikely that the annual cost of maintenance will rise so regularly as to achieve this result, and in any event the tendency for repair and maintenance costs to rise is preferably provided for by the operation of a Repairs and Maintenance Reserve (see Chapter VII).

The real advantage of the method lies in the ease with which it can be applied to the balance of an account in the ledger, including additions to the account since it was first started. That wear and tear allowances for income-tax purposes are usually computed in this way is undoubtedly another factor which has contributed to the extensive use of this method.

When the percentage is to be applied to the balance of an asset account, additions made previously are automatically included in the balance brought forward, but it is necessary to consider how additions and sales during the year are to be dealt with. There are three alternative methods:

(1) The percentage is applied to the balance brought forward at the beginning of the year, additions and sales thus being dealt with, in effect, as though they occurred on the last day of the year.

(2) Additions are added to the balance brought forward and the total is depreciated for a full year.

(3) Separate calculations by reference to the actual date of acquisition which thereafter form part of the balance of the account, and require no further separation.

Method (2) is to be preferred on the ground of simplicity, but Method (3) is more exact and should be used where short-term fixed assets such as motor vehicles are involved.

If Method (2) is applied to the circumstances of the example on page 91, with the difference that a rate of 15 per cent is to be applied by the reducing balance method, instead of 10 per cent by the fixed instalment method, the result is as follows:

PLANT AND MACHINERY

19—					19—				
Jan. 1	To Sundries	12,000	0	0	Dec. 31	By Depreciation (15 per cent on £12,000)	1,800	0	0
						Balance c/d	10,200	0	0
		£12,000	0	0			£12,000	0	0
Jan. 1	To Balance b/d	10,200	0	0	Dec. 31	By Depreciation (15 per cent on £12,200)	1,830	0	0
June 30	Sundries	2,000	0	0		Balance c/d	10,370	0	0
		£12,200	0	0			£12,200	0	0
Jan. 1	To Balance b/d	10,370	0	0	Mar. 31	By Sundries	50	0	0
Mar. 31	Sundries	800	0	0	Dec. 31	Loss on Sale (see *Note*)	311	5	0
						Depreciation (15 per cent on £11,170—£361 5s. 0d.)	1,621	6	3
						Balance c/d	9,187	8	9
		£11,170	0	0			£11,170	0	0
Jan. 1	To Balance b/d	9,187	8	9					

Note. The loss on sale of the machine sold on March 31 is calculated as follows:

	£	s.	d.
Cost	500	0	0
Less Depreciation 1st year	75	0	0
	425	0	0
Less Depreciation 2nd year	63	15	0
Written-down value	361	5	0
Proceeds of sale	50	0	0
Loss on Sale	£311	5	0

The depreciation written off can be accumulated in a separate account, but the calculations are then a little more difficult unless a Plant Register is used. Without a Plant Register the previous example would be worked as follows:

Plant and Machinery Account, being at cost, will be the same as on page 93.

DEPRECIATION ON PLANT AND MACHINERY

		£	s.	d.			£	s.	d.
19—					19—				
Dec. 31	To Balance c/d	1,800	0	0	Dec. 31	By Profit and Loss A/c (15 per cent on £12,000)	1,800	0	0
					Jan. 1	By Balance b/d	1,800	0	0
Dec. 31	To Balance c/d	3,630	0	0	Dec. 31	Profit and Loss A/c (15 per cent on £14,000 – £1,800)	1,830	0	0
		£3,630	0	0			£3,630	0	0
Dec. 31	To Obsolete Machinery	138	15	0	Jan. 1	By Balance b/d	3,630	0	0
	Balance c/d	5,112	11	3	Dec. 31	Profit and Loss A/c (15 per cent on £14,800 – £3,630 – £361 5s.)	1,621	6	3
		£5,251	6	3			£5,251	6	3
					Jan. 1	By Balance b/d	5,112	11	3

Note. The figures taken into account in the calculation of depreciation for the third year are found as follows:

£14,800 is the balance on Plant and Machinery Account representing the cost of the plant owned at the beginning of the year.

£3,630 is the accumulated provision for depreciation brought forward.

£361 5s. is the written-down value (cost less depreciation up to the end of the previous year) of the plant sold during the year.

19—						19—					
Dec. 31	To Plant and Machinery A/c	500	0	0		Mar. 31	By Sundries	50	0	0	
						Dec. 31	Depreciation A/c	138	15	0	
							Profit and Loss A/c	311	5	0	
		£500	0	0				£500	0	0	

3. SINKING FUND METHOD

It has been seen that one of the dual purposes of writing off depreciation of a fixed asset is to provide funds for its replacement at the end of its life. The methods already considered achieve this result indirectly in that the amount written off reduces the profits that would otherwise be available for withdrawal from the business. It is possible, however, that profits will not be earned or that if they are the money representing them will become absorbed in the expansion of the business. When the time comes to replace the fixed asset, therefore, there is no guarantee that the necessary cash will be available.

Methods have consequently been evolved which, by investing the depreciation provisions outside the business, ensure as far as is reasonably possible that the money required will be available at the appointed time. Further, as the amounts so invested will earn interest (which is normally reinvested), such interest will itself provide part of the total sum required to write off and replace the asset, and the annual charge to Profit and Loss Account will thereby be reduced.

A fund built up by investing annually a fixed sum and by reinvesting the interest produced by the investments of the fund is known as a Sinking Fund. The investments chosen will normally be of the type known as gilt-edged, such as British Government securities and the like. Even so it will be necessary to assume that it will be possible to invest money during the currency of the fund on such terms that a known rate of interest will be obtainable. Reference to compound interest or sinking fund tables will then show what must be invested annually to produce the required sum at the end of a given period. The method is best illustrated by an example.

A premium of £10,000 having been paid for a 20-year lease of certain premises, it is desired to build up a Sinking Fund by investing the annual charges for depreciation so that the original £10,000 will be replaced at the end of 20 years. It is assumed that throughout the term of 20 years it will be possible to invest in gilt-edged securities at prices which will show a return of 3 per cent per annum on the amounts invested.

Reference to compound interest tables shows that an investment of £1 a year at the end of each of 20 years will, with the reinvestment on the same terms of the interest received, amount to £26·8704. The amount required to be invested each year to produce the required amount of £10,000 is therefore £$\frac{10{,}000}{26{\cdot}8704}$ = £372 3s. 0d.

The ledger accounts for the first three years will appear as follows:

DEPRECIATION FUND (OR SINKING FUND)

Year 2 To Balance c/d	755	9	3	Year 1 By Profit and Loss A/c	372	3	0
				2 Cash—Interest (3 per cent on £372 3s.)	11	3	3
				Profit and Loss A/c	372	3	0
	£755	9	3		£755	9	3
Year 3 To Balance c/d	1,150	5	6	Year 3 By Balance b/d	755	9	3
				Cash—Interest (3 per cent on £755 9s. 3d.)	22	13	3
				Profit and Loss A/c	372	3	0
	£1,150	5	6		£1,150	5	6
				Year 4 By Balance b/d	1,150	5	6

DEPRECIATION (OR SINKING) FUND INVESTMENTS

Year 1 To Cash	372	3	0	Year 2 By Balance c/d	755	9	3
2 Cash	383	6	3				
	£755	9	3		£755	9	3
Year 3 To Balance b/d	755	9	3	Year 3 By Balance c/d	1,150	5	6
Cash	394	16	3				
	£1,150	5	6		£1,150	5	6
Year 4 To Balance b/d	1,150	5	6				

Provided that it remains possible to invest at 3 per cent throughout, the balance on both accounts will amount to approximately £10,000 at the end of the twentieth year. It will be observed that the amount charged to Profit and Loss Account for depreciation remains constant at £372 3s. per annum; a total charge of £7,463 for 20 years. The remaining £2,537 is provided by interest on investments, the amount of which goes up each year in proportion to the balance invested at the beginning of the year.

On the assumption that the fund is built up to exactly £10,000, the final entries will be as follows:

DEPRECIATION FUND

Year 20 To Leasehold Premises	10,000	0	0	Year 20 By Balance b/f	10,000	0	0

DEPRECIATION FUND INVESTMENTS

Year 20	To Balance b/f	10,000 0 0	Year 20 By Cash (say)	10,000 0 0

LEASEHOLD PREMISES

Year 1	To Sundries (cost)	10,000 0 0	Year 20 By Depreciation Fund	10,000 0 0

There will be £10,000 additional cash at bank representing the proceeds of sale of the sinking fund investments; this will be used for renewing the lease or in whatever other way is deemed to be expedient. The important thing is that the £10,000 of capital originally invested in the lease has been preserved intact although the lease has run out and is of no further value.

POLICY METHOD (VARIATION OF SINKING FUND METHOD)

Even gilt-edged investments are liable to fluctuate in value; there can therefore be no certainty that the investments when realized will produce as much as is required. Any loss on realization will have to be written off to Profit and Loss Account, as it represents a deficiency in the amount provided for depreciation by the use of the sinking fund method.

This risk of loss on realization can, however, be guarded against by making use of the services of a reputable insurance company. For a fixed annual premium (usually payable in advance at the beginning of each year) the insurance company will issue a sinking fund or fixed endowment policy under which the capital sum required for replacement of the wasting asset will be paid out at the expiration of a given term of years. The amount paid under such a policy represents the accumulation of the premiums at a low rate of compound interest, the slight loss of interest as compared with direct investment in gilt-edged securities representing in effect an insurance against loss on realization.

If this method is followed the annual premium represents the charge to be made to Profit and Loss Account for depreciation of the asset. The existence of the policy can be recorded in the books by opening a Sinking Fund Policy Account and a Depreciation Fund Account.

4. REVALUATION

Depreciation of certain classes of assets, notably loose-tools and horses, cannot be satisfactorily calculated by the methods already described. In such cases, it will probably be necessary to revalue the whole asset at the end of the trading period and write off the depreciation (resulting from such revaluation) to revenue in the usual way.

Floating assets may also be subject to depreciation in the sense that they may ultimately realize less than their original value. For example, amounts due to a trader (Sundry Debtors) may become wholly or partially irrecoverable. Goods bought for resale may fall in value before they can be sold and may ultimately be realized at a loss. Such losses are not

inherent in the nature of the asset, however, and they cannot be provided for by the process of writing off an annual amount of depreciation.

Expected losses on realization of book debts are met by creating the appropriate reserves or provisions; these are considered in Chapter VII. Depreciation of stock, on the other hand, is a matter to be dealt with in the valuation of that asset.

VALUATION OF STOCK-IN-TRADE

It has been seen that one of the closing entries that has to be made before the Trading Account can be prepared incorporates the value of the stock-in-trade on the date of the Balance Sheet. This stock is normally valued at cost price to eliminate from the Trading Account the cost of the goods purchased but not resold during the year under review.

In some businesses it is possible to keep detailed stock records from which can be extracted a schedule of the goods in stock at any given date. When this is impracticable, the value of the stock is ascertained by taking an inventory of the goods actually in stock at the required date. The person who takes stock must possess sufficient technical training and ability to be able to recognize the various classes and qualities of the goods in the warehouse or elsewhere. This knowledge is not necessarily possessed by a book-keeper or accountant, as such; the book-keeper therefore normally gives effect to a valuation that has been prepared by someone else. In some trades it is usual to employ the services of a professional stocktaker for this purpose.

The valuation of stock is nevertheless a matter involving important principles of accountancy. The guiding principle is that credit should not be taken for profits before they are realized, but full provision should be made for losses as soon as there is any reason to fear that they will be incurred. Thus, while stock is never (normally) valued at a price in excess of cost, since that would amount to taking credit for an unrealized profit, it will be necessary to write it down to its realizable value when that is below cost price. In general terms, therefore, it may be stated that the correct basis of valuation of stock-in-trade is cost or market (realizable) value, whichever is the lower. The terms cost and market value are not always easy to apply, and require further consideration.

CALCULATION OF COST PRICE

When individual items in the stock inventory can be identified as having been purchased on a given date at a given price, the calculation of cost presents little difficulty. In such cases the goods are said to be valued at *actual cost*.

This physical identification of the goods is not always possible, however. An ironmonger, for example, might have purchased several quantities of 1-in. nails at varying prices on different dates during the past year, placing them all in the same receptacle or bin, from which he takes them as required. The quantity in stock at the end of the year can be weighed (or estimated) but the actual cost of that item in his stock list cannot be inserted. Various methods have been evolved for the calculation of cost price in such cases, of which the following are the most important:

(1) *First In, First Out.* This method assumes that the goods first bought are the first to be sold; the stock in hand therefore represents goods purchased at the most recent dates. For example, if the ironmonger had bought 2 cwt. of 1-in. nails on October 1 at 20s. per cwt., and 2 cwt. on December 10 at 25s. per cwt., and had 3 cwt. in stock on December 31, he would value that stock as follows:

2 cwt. last purchased at 25s. per cwt.	2 10 0
1 cwt. from previous purchase at 20s. per cwt.	1 0 0
	£3 10 0

(2) *Average Cost.* The literal application of the first in, first out principle may involve rather complicated calculations which would be out of place when valuing the stock of a small concern. To meet this objection, and for other reasons which are considered in connexion with Costing (Chapter XX), stock is commonly valued at the average price at which purchases of that commodity have recently been made. In the example considered above this would result in the stock of 3 cwt. of nails being valued at an average cost of 22s. 6d. per cwt., or £3 7s. 6d.

Other methods that may be encountered are the fixed-price method (only possible when prices are reasonably stable), the last in, first out method (designed to charge the Trading Account with the cost of replacing the goods that have been sold) and the basic stock method (where a basic minimum stock of each item is valued at its original cost, being regarded in effect as original capital expenditure, while excesses over that minimum are valued according to one of the other methods).

CALCULATION OF MARKET PRICE

The ascertainment of market price raises the question of replacement price against realization price. In a purely merchanting concern where goods are bought and then resold in the same condition, the trader, whether he be a wholesaler or a retailer, normally works to a fairly definite margin of gross profit. Thus, a wholesaler may buy goods from a manufacturer for £100, intending to resell them to the retail trade for £125. If market prices fall the position may arise that at the date of his Balance Sheet the trader could buy for £90 (intending to resell at £112 10s.) the goods which he actually bought for £100 a month or two earlier and still has in stock. It cannot be said that a loss has, as yet, to be anticipated.

If the goods are in fact sold for £112 10s. there will be a reduced gross profit of £12 10s. instead of the £25 that was originally expected. In such cases, therefore, it cannot be regarded as necessary to write down the stock below cost; its realizable value is still in excess of cost.

On the other hand, if the price had fallen to a greater extent so that the current replacement cost of similar goods would be £60, with a realizable value of £80, it is clear that the stock must be written down from £100 to £80 at the most. It is also necessary to consider whether there is likely to be any further fall in value before the goods are sold. This is particu-

larly important when the trade is of a seasonal nature and goods unsold at the end of one season may have to be retained in stock for a year and then sold at a very much reduced price.

Further, when realizable values are being substituted for cost price in stock valuations it is necessary to provide for the cost of realization. Thus, apart from other considerations, the wholesaler may pay his traveller a commission of 5 per cent on the value of goods sold by him. In that case the £80 realizable value considered in the last example would have to be reduced by £4 in respect of this commission alone. Other selling expenses might have to be taken into account in a similar way, and in such cases it may well be desirable to base the valuation on cost of replacement, without any consideration of selling costs.

EXCEPTIONS TO THE GENERAL RULE

Although the rule of valuation—cost or market price, whichever be the lower—is one of the fundamental axioms of sound accountancy, it is subject to exceptions of which the following are the most important:

(1) In some trades (such as those dealing in timber or whisky) stocks are held for periods which may extend over several years until they mature and are ready for sale. Under normal conditions the stock is increasing in value throughout this period and it would not be reasonable to carry it in the books at original cost price. An addition to cost is normally made, representing interest on the capital locked up in such stocks. The exception is not carried to the length of substituting market values for cost prices.

(2) Plantations (such as tea or rubber estates) normally bring in their stocks of produce at prices realized since the date of the Balance Sheet (less costs of realization). This is to enable the Trading Account to show the result of a crop rather than of a given financial year.

(3) Manufacturing and other concerns which do not merely buy goods and resell them in the same state have various problems to overcome in the calculation of cost or market value. Further, their stocks may have to be considered under different headings, such as raw materials, partly manufactured goods (work-in-progress) and finished stocks. These problems are dealt with in connexion with Manufacturing Accounts and Costing (Chapter XX).

GOING-CONCERN VALUE

It has been seen that there is a fundamental difference between the bases of valuation of fixed assets and floating assets respectively. Fixed assets are normally valued for Balance Sheet purposes at cost less depreciation; their actual or realizable values at any given date may be either more or less than the values so obtained. An entirely different criterion is applied to floating assets, which appear at the lower of cost or realizable values. This apparent inconsistency is inherent in the different purposes for which fixed and floating assets are held. The combination of the two kinds of assets, and therefore of the two methods of valuation, emphasizes that the function of a Balance Sheet is to show the value of the assets on a "going-concern" basis.

When it is not intended to continue to carry on the business (for example, when bankruptcy proceedings have been commenced) it is necessary to depart from the going-concern basis and to consider the realizable value (whether more or less than book value) of all the assets. A document which sets out these values, however, is not a Balance Sheet at all; it is known as a Statement of Affairs.

QUESTIONS AND EXERCISES

(Key to answers on page 570).

(1) Define depreciation. What is the purpose of providing for depreciation and what factors must be taken into account in calculating the rate to be employed?

(2) What considerations determine whether an asset is a fixed or floating one; how can an asset be a fixed one in one business and a floating one in another?

(3) What are the main methods of calculating depreciation?

(4) Enumerate the advantages and disadvantages of the sinking fund method. For which class of asset is it most suitable?

(5) What is, and what are the main uses of, a Plant Register?

(6) Why is it usual to provide for the depreciation of fixed assets?

Machinery, value £2,500, is purchased and installed by a firm on January 1, 1950. It is estimated that it will last ten years and will have a residual value of £350. Show the Machinery Account for the years 1950 and 1951.

(*L.C. of C. Certificate*).

(7) On December 31, 1937, a limited company purchased certain machines at a cost of £6,000. As the effective life of these machines was not more than eleven years a Sinking Fund was created and duly invested from time to time in order to provide funds for the purchase of machines to replace these. At the end of the eleven years the relevant items on the company's Balance Sheet were as follows:

Balance Sheet, December 31, 1948

Sinking Fund Account	£6,000	Machinery Account	£6,000
		Investments	6,000

Assuming the investments realized the exact sum as shown on the Balance Sheet and the company purchased further machinery at the same figure, give the necessary entries in the Cash Book, and set out the appropriate ledger accounts in the company's books. (*A.C.C.A. Inter.*).

(8) A manufacturer depreciates his machinery on the footing that equal amounts of depreciation are deemed to occur in respect of each unit in equal periods of time. He carries all purchases of machinery to a single Plant and Machinery Account, and records depreciation therein.

Given the facts below, you are required to construct the Plant and Machinery Account as it would appear for the five years 1943 to 1947 inclusive. The manufacturer balances his books every December 31.

	£
Jan. 1, 1943. Purchased a machine for cash. (Estimated life 10 years, scrap value £10)	200
Mar. 31, 1944. Purchased from Jones, on credit, a machine. (Estimated life 5 years, scrap value £20)	100
June 30, 1945. Purchased for cash a machine. (Estimated life 2 years, scrap value nil)	60
Sept. 30, 1946. Purchased for cash a machine. (Estimated life 8 years, scrap value £30)	350
Jan. 1, 1947. Purchased for cash a machine. (Estimated life 10 years, scrap value £10)	120

(*Inst. of Bankers, Part I*).

(9) A manufacturing business has a quantity of plant, in respect of which it regularly provides depreciation by writing off 10 per cent of the balance standing to the debit of Plant and Machinery Account at the end of each accounting year (December 31). In addition, it transfers £500 each year from the Manufacturing Account to the credit of a Machinery Renewal and Replacement Reserve, and to this last-named reserve is also transferred any profit or loss arising on the sale of scrapping of plant.

On January 1, 1943, the balance on Plant and Machinery Account was £27,660 and the Renewal Reserve stood at £3,190.

Additions to plant in the following years were: 1943, £2,300; 1944, nil; 1945, £6,800; 1946, £9,300. Sales were: 1943, nil; 1944, £1,750 (cost in 1940, £2,400); 1945, nil. In 1946 a quantity of plant, bought in 1937 for £5,000, was sold for scrap, realizing £60.

Write up the Plant and Machinery Account and the Renewal and Replacement Reserve for the years 1943 to 1946 inclusive, all calculations of depreciation being made to the nearest £. (*R.S.A. Stage III*).

(10) Early in 1943, Z, Ltd., which prepares accounts annually to December 31, bought a quarry. The price was £35,000 and as it was estimated that the quarry would be exhausted and valueless in about 30 years the directors took out a redemption policy to yield £35,000 in 1974; the annual premium to secure this policy is £673, payable on May 1, the first premium being due on May 1, 1943, and all premiums were paid on their due dates. It was decided:

(*a*) To let the quarry stand in the books at cost;

(*b*) To charge the premiums to a Policy Account, to be kept at cost or surrender value, whichever was the greater, and

(*c*) To charge revenue each year with an amount equal to the premium.

The following table shows the surrender value of the policy on December 31 in each of the first five years:

31 December, 1943	£651
,, ,, 1944	1,321
,, ,, 1945	2,011
,, ,, 1946	2,722
,, ,, 1947	3,454

You are required to write up the Policy Account, and any other account you may consider necessary in connexion with this transaction, from the commencement up to December 31, 1947, and to show the position as it would be disclosed by the Balance Sheet as on the latter date. (*L.C. of C. Higher*).

(11) A manufacturing business owns a quantity of plant, depreciation on the whole of which is provided at the rate of 15 per cent per annum on the diminishing balance. Accounts are prepared annually to June 30 and the book value of the whole of the plant as on June 30, 1948, was £17,541 10s.

On September 30, 1948, additional plant was purchased, costing £1,220, and on December 31, 1948, further plant costing £475. On March 31, 1949, some old plant was sold for £235, the book value of which as on June 30, 1948, was £250.

You are required to write up the Plant Account for the year to June 30, 1949. (*Chartered Accountants, Inter.*).

(12) Jackson & Co., who had paid £15,000 for a long lease of certain premises, had taken out a leasehold redemption policy, the annual premium payable being £386. Up to September 30, 1948, eight premiums had been paid, but as the surrender value of the policy on that date, £3,192, was greater than the total of the premiums paid, the Policy Account had been written up to this figure. The ninth premium was paid on June 26, 1949, and the surrender value of the policy on September 30, 1949, was £3,609.

Set out the Redemption Reserve Account and the Policy Account as they would appear in the firm's books for the year ended September 30, 1949. (*Chartered Accountants, Inter.*).

CHAPTER VII

RESERVES AND PROVISIONS

It was seen in Chapter V that many adjustments may be necessary before the amounts shown in a Trial Balance can be correctly set out in the form of annual accounts. For example, an expense such as rent payable, that has accrued at the date of the Balance Sheet, has to be brought into account by carrying down a credit balance on Rent Account.

At one time this process would have been known as "reserving" for rent accrued and the credit balance carried down on Rent Account would have been called a *reserve*. Modern practice, however, discards this use of the word reserve and refers either to a *provision* for rent accrued or, more simply, to an accrued liability for rent.

The expression reserve is now properly used only to signify a sum set aside out of profits for a more general purpose; that is, it does not relate specifically to some known loss or expense that has already been incurred. It covers *possible* losses or expenses, either present or future, but not *actual* losses or expenses, for which suitable *provision* must always be made.

Where limited companies are concerned, the expressions reserve and provision are now given precise meanings which govern their use; these are considered in Chapter XIII.

In what follows it must be borne in mind that the principal aim of the book-keeper when preparing annual accounts is to ensure that the Profit and Loss Account gives a true and fair view of the profit or loss for the period under review and that the Balance Sheet exhibits a true and fair view of the trader's financial position (according to "going-concern" principles) at the end of it. The achievement of these aims is of greater importance than an over-pedantic insistence on certain usages of words.

ACCRUED EXPENSES

It has already been seen that where expense accounts in the General Ledger are written up in the main by direct postings from the Cash Book it is necessary to provide for amounts that have accrued due but are unpaid at the date of the Balance Sheet. Such a provision may represent an amount that had actually fallen due for payment on or before the Balance Sheet date, but was not actually paid until after that date. Alternatively, it may represent an accrual; that is to say, the proportionate part of a liability that will not fall due for payment until after the Balance Sheet date.

For example, if a trader occupies certain premises at a rental of £240 a year, payable quarterly in arrear on the usual quarter days, and he does not pay until January 5 in the following year the rent of £60 already due on December 25, then:

(1) If he makes up his final accounts for the year on December 31 it

will be necessary to make provision for one quarter's rent due on December 25 but unpaid on December 31. (Strictly, provision should also be made for rent accrued for a further six days from December 25 to 31, but in practice such minor adjustments are frequently ignored unless the amount involved is substantial.)

(2) If, on the other hand, his Balance Sheet date is November 30, although there is nothing actually owing to the landlord on that date, provision must be made for £40 rent accrued from September 29 to November 30 (again calculating to the nearest month).

If this adjustment were not made the Profit and Loss Account for the year ended November 30 would not contain a correct debit for rent (unless, indeed, a similar adjustment at the beginning of the year had been ignored, in which case the Profit and Loss Account for some earlier year would have been wrong).

When an expense accrues evenly on a day-to-day basis, although payable only at longer intervals, the calculation of the accrued liability at any given date, as in the examples involving Rent Account, presents no difficulty. Expenses do not always accrue in this way, however. The cost of lighting a trader's business premises, for example, will usually be defrayed by paying the quarterly accounts received from the local office of the Electricity Authority. An account received on January 30 may represent the charge for electricity up to a meter-reading on or about the end of the previous month.

If, therefore, the Balance Sheet date is December 31 and the books are not finally balanced until after the end of January, the sum to be provided for the accrued liability on December 31 will be the amount of the account subsequently received. If, however, it is not expedient to wait a month before closing the books the trader will be forced either to make his own calculation of the liability by reading the meter himself on the appropriate date, or alternatively he will have to estimate it to the best of his ability.

In making such an estimate he would have to take into account the seasonal nature of the expenditure, if he had not read the meter in order to make an exact calculation. A similar procedure would be essential if the date of the Balance Sheet differed materially from the date to which the electricity account is normally rendered.

Some types of expenditure do not accrue in respect of any regular period of time but arise at irregular intervals. *Legal expenses*, for example, are incurred when the trader has to take legal advice or to bring or defend actions at law. Provision must be made for outstanding expenses of this nature at the date of the Balance Sheet. Pending the receipt of a formal bill of costs the provision must be estimated as accurately as possible.

Audit fees are usually provided for as an expense relating to the period for which the accounts are to be audited, although as a general rule the auditors will not carry out their work until after the date of the Balance Sheet. Where the audit fee is agreed in advance at a fixed fee this presents no difficulty, but in other cases the auditors will be the best judges of the amount that ought to be provided.

Insurance premiums are normally payable in advance, but provision for an accrued liability may be necessary in the following circumstances:

(1) Where a premium payable in advance became due on some date earlier than that of the Balance Sheet but was not paid until later.

Example

A trader whose premises are insured against fire at a premium of £12 payable annually in advance on September 29 makes up his Balance Sheet on October 31. If the premium due on September 29 was not paid until November 5 it will be necessary to provide for £1 as an accrued expense in the Balance Sheet as at October 31.

(2) For certain types of insurance, of which the most important examples are Employers' (Common Law) Liability and Third Party Risks, the premium is not a fixed annual amount but is expressed as a percentage of wages paid during the risk period. A provisional payment is made at the beginning of the period based on the estimated liability. Sometimes this estimate proves to be much below the true amount, so that if a Balance Sheet has to be drawn up at a date near to the end of the period covered by the insurance there may be a substantial liability for an excess premium.

Example

The X Contracting Company on April 1 effected an employer's liability insurance for the year commencing on that date at a premium of £2 per cent on wages payable. The initial premium was £2,000 based on an estimated wages bill of £100,000 for the year.

The company makes up its annual accounts on December 31 and finds that in the period April 1 to December 31 wages amounting to £140,000 have been paid. Provision must be made in Insurance Account for the accrued excess premium as follows:

	£
Premium accrued at £2 per cent on £140,000	2,800
Less Premium paid on April 1	2,000
Excess premium accrued to date	£800

Wages are normally paid weekly and the total amount paid out for the week is usually posted to Wages Account as on the date of payment. Unless the date of the Balance Sheet happens to coincide with a pay-day there may appear to be an accrued liability of from one to six days' wages according to the date of the last pay-day in the financial year. Before deciding that this is the correct amount to provide for as an accrued liability, however, the following possibilities should be considered:

(1) In some industries arrears may range from a few days to possibly two weeks. For example, in a certain trade wages earned up to Tuesday night may be paid on the following Friday. If a Balance

Sheet is to be made up to March 31 and in a given year that date falls on a Thursday the total amount of wages accrued will be: (*a*) the amount actually paid out on April 1 for the week ended Tuesday, March 29, plus (*b*) the amount accrued for the two days, Wednesday and Thursday, March 30 and 31, respectively.

(2) Against the theoretical necessity of reserving in full for the accrual as calculated above it is necessary to consider whether the fruits of the labour so provided for will appear as an asset. In the Balance Sheet of any sort of constructional business an important asset is work-in-progress, that is, the cost of work done up to the date of the Balance Sheet but not yet charged out to customers. If, as is usual, the valuation of work-in-progress is based on the record of wages actually paid up to date of the Balance Sheet, it would be incorrect to reserve for accrued wages unless a corresponding addition is made to the work-in-progress valuation.

Salaries, on the other hand, are frequently paid monthly on the last day of the month and in such cases if the Balance Sheet, as is usual, is also drawn up at the end of a month, no accrual would appear to arise. It is necessary to consider whether any exceptional remuneration, such as a bonus or commission, is outstanding or will arise as a result of the year's trading; if so, due provision must be made for it.

Sufficient examples have been given to show that nearly every debit item in the Profit and Loss Account may give rise to a provision for accrued expense. The book-keeper should in fact scrutinize every nominal account in the General Ledger and, before closing it by transfer to Profit and Loss Account, consider whether such an adjustment is necessary. The following tests may usefully be applied to each account:

(1) What does the amount that is to be transferred to Profit and Loss Account represent? Is it the full amount of that particular type of expenditure for a year? If not, what provision is necessary to bring up the debit to the full amount? (For example, if rent is known to be £200 a year but the Trial Balance before adjustments shows a debit of £150, rent for one quarter, £50, is presumably outstanding and must be provided for.)

(2) Is there any known liability of that nature outstanding at the date of the Balance Sheet (such as legal expenses)?

(3) Was any provision for accrued expenditure brought forward at the beginning of the year; if so, will not a similar provision (not necessarily of the same amount) be required now?

When all the necessary provisions have been calculated, effect is given to them by carrying down credit balances on the account concerned.

Example

A trader commenced business on January 1 in premises which he rents at £400 per annum, payable quarterly in arrear on the usual quarter-days. Payments of rent were made (£100 each) on the following dates in order: March 26, June 30, September 30, January 2, April 5, July 6, October 2, December 29, April 6, July 10, October 12.

Show his Rent Account for the first three years of trading, making any necessary provisions to the nearest month.

RENT

			£				£
19—				19—			
Mar. 26	To Cash		100	Dec. 31	By Profit and Loss A/c		400
June 30	,,		100				
Sept. 30	,,		100				
Dec. 31	Balance, Rent accrued for 1 qtr.	c/d	100				
			£400				£400
19—				19—			
Jan. 2	To Cash		100	Jan. 1	By Balance	b/d	100
Apr. 5	,,		100				
July 6	,,		100	Dec. 31	Profit and Loss A/c		400
Oct. 2	,,		100				
Dec. 29	,,		100				
			£500				£500
19—				19—			
Apr. 6	To Cash		100	Dec. 31	By Profit and Loss A/c		400
July 10	,,		100				
Oct. 12	,,		100				
Dec. 31	Balance, Rent accrued for 1 qtr.	c/d	100				
			£400				£400
				19—			
				Jan. 1	By Balance	b/d	100

OTHER CREDIT ADJUSTMENTS

If income is received in advance of the period to which it relates, it is necessary to carry forward to the next period an appropriate amount; otherwise the profit for the period under review will be overstated:

Example

A trader sub-lets part of his business premises to a sub-tenant who agrees to pay a rental of £200 a year, quarterly in advance, on the usual quarter-days. During the year ended December 31 the trader received £250 from his sub-tenant, including £50 on December 29 for the quarter just commenced. Rent Receivable Account will appear as follows (dates assumed):

			£				£
19—				19—			
Dec. 31	To Profit and Loss A/c		200	Jan. 2	By Cash		50
	Balance, Rent received in advance	c/d	50	Apr. 1	,,		50
				July 1	,,		50
				Sept. 30	,,		50
				Dec. 29	,,		50
			£250				£250
				19—			
				Jan. 1	By Balance	b/d	50

Although the resulting credit balance of £50 is not in the strict sense a liability, it would be carried into the Balance Sheet under the heading Provision for Accrued Expenses, as part of the total of credit balance adjustments in the Nominal Ledger. In fact, all the credit balance adjustments considered so far have one thing in common: they appear on the liabilities side of the Balance Sheet whether or not they represent liabilities actually due for payment.

DEBIT ADJUSTMENTS

Perusal of the nominal accounts may in some instances reveal debit balances which are in excess of the full charge under that heading for the year or other period under review. This generally arises where expenses have been paid in advance; an example was considered on page 81 in relation to an insurance premium. A more comprehensive example, which shows that adjustments for accrued expenses and payments in advance can arise in the same account, is as follows:

Example

A trader rents premises at £400 a year, payable quarterly in arrear on the usual quarter-days, and makes the following payments to his landlord in the year under review: March 26, £100; July 6, £100; October 10, £100. He pays rates as follows:

	£
On February 6 for the 3 months ended March 31	30
On June 10 ,, 6 ,, ,, September 30	70
On December 5 ,, 6 ,, ,, March 31 following year	70

He uses a combined Rent and Rates Account in his General Ledger, which will appear as follows:

			£				£
19—				19—			
Feb. 6	To Cash (Rates)		30	Dec. 31	By Profit and Loss A/c		535
Mar. 26	,, (Rent)		100		Balance, Rates paid in advance for 3 months	c/d	35
June 10	,, (Rates)		70				
July 6	,, (Rent)		100				
Oct. 10	,, (Rent)		100				
Dec. 5	,, (Rates)		70				
31	Balance, Rent accrued for 1 qtr.	c/d	100				
			£570				£570
19—				19—			
Jan. 1	To Balance	b/d	35	Jan. 1	By Balance	b/d	100

Other debit balance adjustments arise wherever there exists at the Balance Sheet date any item capable of valuation which is not yet recorded in the books but which has to be brought into account to enable the Profit and Loss Account to exhibit the true result of trading for the period under review. An example of such an adjustment was seen on page 80, when the outstanding insurance claim was brought into account as an asset. The adjustment for closing stock is really also of this nature.

Adjustments of the nature of payments in advance are sometimes referred to as Deferred Revenue Expenditure, because they relate to

expenditure which is of a revenue (that is, profit or loss) nature and has actually been incurred before the date of the Balance Sheet, but which is nevertheless carried forward into the next period which actually receives the benefit of that expenditure. Under this heading adjustments are sometimes made which are of a more controversial nature than those already considered.

For example, if in a given year abnormally heavy expenditure is incurred on an advertising campaign by way of newspaper advertisement, it may be argued that the benefit of this expenditure will be felt in the following year and perhaps for several years after the one in which the exceptional expenditure is incurred. It may therefore be decided to carry forward part of the expenditure as a debit balance in the books.

This necessarily involves showing it as an asset in the Balance Sheet, where it may be described as Advertising Suspense Account or be given some other name which clearly indicates its nature. It should not be covered up by calling it Goodwill, although it is sometimes argued that advertising expenditure does create goodwill. As a general rule, the whole amount carried forward at the end of one year should be written off in the following year unless there are very exceptional circumstances to justify a further carry-forward.

BAD DEBTS

Any debt known to be irrecoverable should be written off to Bad Debts Account; there is no point in carrying the balance forward in the Sales Ledger, and the profits will be overstated if a sufficient charge for bad debts is not made. Long before a debt is definitely known to be irrecoverable, however, the chances of recovering it may be exceedingly remote. For example, the customer who owes this debt may have moved away from his last known address and all attempts to trace him may have failed; nevertheless he still owes the balance due from him and one day he may return and pay it, in an effort to re-establish his credit.

If such debts were written off as bad there would no longer be a record, in the form of a Sales Ledger balance, of the amount outstanding; some chance of following up the debt might thereby be lost, or if it is eventually recovered it might be misappropriated by a dishonest employee. While any reasonable chance remains of collecting a debt either in full or in part, therefore, it is generally considered desirable to retain the balance in the Sales Ledger. On the other hand, the Profit and Loss Account will overstate the profit and the Balance Sheet will not show the true position unless some provision is made to cover the bad debt that will probably arise.

By creating a reserve or provision for bad debts, proper allowance can be made for this loss in the year in which the debts become bad, but the balances in the Sales Ledger are carried forward until either they are recovered in full or in part, or it becomes clear that they are definitely irrecoverable and ought to be written off. If the provision is designed to cover specific amounts in the schedule of Sales Ledger balances it is usually treated as a provision for an accrued expense, by carrying forward a credit balance on Bad Debts Account.

Example

On examining the schedule of Sundry Debtors extracted from a trader's Sales Ledger on September 30, it is decided to write off as bad, debts of £10 2s. 3d. and £21 6s. 8d. due from A and B respectively. It is also decided to provide in full against debts of £6 9s. 2d., £30 1s. 8d. and £17 9s. 10d. due from C, D and E respectively, but not to write off these three balances in the Sales Ledger.

During the following year, on April 1, a first and final dividend of 10s. in the £ was received in the bankruptcy of C, and on June 1 a dividend of £3 was unexpectedly received from A's trustee in bankruptcy.

On September 30 it was decided to write off as bad a debt of £51 10s. 8d. due from F and to provide in full against balances of £6 1s. 7d. and £29 17s. 6d. due from G and H respectively. No further payment had been received from D or E.

The Bad Debts Account for the two years covered by the above transactions would appear as follows:

BAD DEBTS

19—								19—				
Sept. 30	To A				10	2	3	Sept. 30	By Profit and Loss A/c	85	9	7
	B				21	6	8					
	Balance, Provision c/d				54	0	8					
	re C	6	9	2								
	re D	30	1	8								
	re E	17	9	10								
		54	0	8								
					£85	9	7			£85	9	7
19—								19—				
Sept. 30	To C				3	4	7	Oct. 1	By Balance b/d	54	0	8
	F				51	10	8	June 1	Cash of A's Trustee	3	0	0
	Balance, Provision c/d				83	10	7	Sept. 30	Profit and Loss A/c	81	5	2
	re D	30	1	8								
	re E	17	9	10								
	re G	6	1	7								
	re H	29	17	6								
		83	10	7								
					£138	5	10			£138	5	10
								19—				
								Oct. 1	By Balance b/d	83	10	7

Notes. (1) The cash received from C's trustee in bankruptcy on April 1 will be credited to C's account in the Sales Ledger against the debit balance of £6 9s. 2d. which was being carried forward thereon. As this is a first and *final* dividend the balance of £3 4s. 7d. is clearly irrecoverable and is therefore written off to Bad Debts Account. It is therefore unnecessary to include any

amount in res... in the provision at the end of the second year as the wh... ...e amount previously reserved has either been written off o... ...overed.

(2) The amount ...ansferred to Profit and Loss Account at the end of the second yea... represents the bad debts actually incurred or provided for for the ...irst time in that year, less recoveries of amounts previously writte... off or provided for, thus:

		£ s. d.	£ s. d.
Debt written off—F			51 10 8
Debts provided for in full for firs... time:	G	6 1 7	
	H	29 17 6	
			35 19 1
			87 9 9
Less Recoveries:			
Debt written off in previous year,	A (part)	3 0 0	
Debt provided for in full in previous year,	C (part)	3 4 7	
			6 4 7
			£81 5 2

In addition to the provision against debts which are expected to be wholly irrecoverable (generally known as a *Specific* Provision for Bad Debts) it may also be desirable to make a general reserve against debts which are of doubtful value, although it cannot yet be said that they are valueless. At the date of a Balance Sheet the value of every balance in the Sales Ledger is dependent on realization. In some circumstances the risk of bad debts may be very small, but it usually exists in some degree. Therefore, in order to avoid taking credit for profits that may not ultimately be realized, some traders adopt the practice of creating each year a Reserve for Bad and Doubtful Debts, which is usually calculated as a percentage on the outstanding Sales Ledger balances and is quite distinct from the provision (if any) already considered. The percentage to be applied is not necessarily the same each year, for the risk of bad debts tends to vary according to the state of trade. In prosperous times few traders are insolvent and the risk is small, whereas in times of trade depression the risk may be considerable.

A *General* Reserve for Bad and Doubtful Debts is not as a rule carried forward as a credit balance on Bad Debts Account but is maintained in a separate account in the General Ledger. It will give rise either to a debit or a credit in Profit and Loss Account according to whether the reserve at the end of the year is more or less than the reserve brought forward.

Example

At the end of his first year's trading, March 31, a trader decides to create a Reserve for Bad and Doubtful Debts equivalent to 5 per cent on his Sales Ledger balances, which total £2,500. At the end of the following year the balances amount to £3,000 and a reserve of 5 per cent is again considered sufficient. At the end of the third year,

due to depression in trade, the balances only £1,800, but it is decided to increase the reserve to 7½ pe thereon.

The reserve will appear as follows in the General Ledger:

RESERVE FOR BAD AND DOUBTFUL DEBTS

Date	Particulars		£	Date	Particulars		£
19—				19—			
Mar. 31	To Balance, 5 per cent on £2,500	c/d	125	Mar. 31	By Profit and Loss A/c		125
19—				19—			
Mar. 31	To Balance, 5 per cent on £3,000	c/d	150	Apr. 1	By Balance	b/d	125
				19—			
				Mar. 31	Profit and Loss A/c		25
			£150				£150
19—				19—			
Mar. 31	To Profit and Loss A/c		15	Apr. 1	By Balance	b/d	150
	Balance, 7½ per cent on £1,800	c/d	135				
			£150				£150
				19—			
				Apr. 1	By Balance	b/d	135

It will be observed that although the percentage rate of the reserve is higher at the end of the third year than it was at the end of the second year the amount of the reserve is lower. In consequence, the Profit and Loss Account for the third year will contain a credit for "Reduction in Reserve for Bad and Doubtful Debts, £15."

PROVISIONS FOR DISCOUNTS

(1) *Discounts Allowable.* As trade discounts are deducted from amounts invoiced to customers before the appropriate entry is made in the Sales Day Book it can never be necessary to create a provision for trade discount allowable; all the balances in the Sales Ledger are necessarily net balances after deduction of trade discount. *Cash discount*, on the other hand, is not entered in the books until the customer pays his account and thus earns the right to deduct cash discount.

If the discount is regarded literally as being earned on the date of payment, then from the point of view of the trader who allows the deduction it is a loss or expense incurred on the date when his customer pays him. Consequently, on the date of the Balance Sheet, although the entry Sundry Debtors contains many items which will never be received in full, because cash discount will be deducted by the customers when they settle their accounts early in the new year, it may be argued that this discount that will be, but has not yet been, allowed is properly regarded as an expense to be borne in the next financial year.

On the other hand, it is perhaps more correct to regard cash discount as a financial expense that is akin to interest on money (credit) lent. If,

therefore, a customer bought goods on, say, December 3 and paid for them on January 2, deducting 2½ per cent cash discount for payment within the month, he may be regarded as having earned practically the whole of the discount during the period December 3 to 31. Conversely, the trader who sold the goods to him ought to be regarded as having incurred an expense of a similar amount in that period.

Under the system of double-entry book-keeping already considered it would be incorrect to make any specific entry for cash discount in a customer's account in the Sales Ledger before he has actually paid his account; it is, however, just as easy to create a Provision for Discounts Allowable as it is to create a Reserve for Bad Debts, and the procedure is similar. Provisions for discounts are nearly always of a general nature and are therefore calculated in the form of a percentage on Sundry Debtors. It should be noted that where reserves or provisions for discounts and for bad debts are to be created in respect of the same total of Sundry Debtors, the Provision for Discount is calculated on the net balance remaining after deduction of the Bad Debts Reserve, as the same account cannot very well be bad and yet so good that discount will hvae to be allowed on it.

Example

In the circumstances of the example on page 114 it is decided also to create a Provision for Discounts equivalent to 2½ per cent on the net Sales Ledger balances outstanding on each Balance Sheet date. The Provision for Discounts will appear in the General Ledger as follows:

PROVISION FOR DISCOUNTS ALLOWABLE

Date	Particulars		£	s	d	Date	Particulars		£	s	d
19— Mar. 31	To Balance, 2½% on £2,500—£125 = £2,375	c/d	59	7	6	19— Mar. 31	By Profit and Loss A/c		59	7	6
19— Mar. 31	To Balance, 2½% on £3,000—£150 =£2,850	c/d	71	5	0	Apr. 1	By Balance	b/d	59	7	6
						19— Mar. 31	Profit and Loss A/c		11	17	6
			£71	5	0				£71	5	0
19— Mar. 31	To Profit and Loss A/c		29	12	6	19— Apr. 1	By Balance	b/d	71	5	0
	Balance, 2½% on £1,800—£135 = £1,665	c/d	41	12	6						
			£71	5	0				£71	5	0
						19— Apr. 1	By Balance	b/d	41	12	6

The relative entries in the Balance Sheet at the end of the first year will be:

	Sundry Debtors		2,500 0 0	
	Less Reserve for Bad Debts	125 0 0		
	Provision for Discount	59 7 6	184 7 6	2,315 12 6

(2) *Discounts Receivable.* If it is considered correct and prudent to provide for discounts that will be allowable by a trader in respect of his Sales Ledger balances at the date of the Balance Sheet, it may also be urged that many of the Bought Ledger balances, which will appear in the Balance Sheet in total as Sundry Creditors, will in fact be paid under discount early in the new year. If the customers were regarded as having earned, in part at least, the right to deduct some of the discount allowable, the trader may equally be regarded as having earned part of the discount that he will ultimately deduct when he pays his creditors, and to that extent the Profit and Loss Account of the current year should receive a credit for such discount. This can be effected by creating a Provision for Discount Receivable which will be similar in operation but opposite in effect to the Provision for Discount Allowable.

Example

It is decided to provide 2 per cent on the outstanding Bought Ledger balances for discount receivable. The amounts of these balances on June 30 at the end of two successive years were £6,420 and £5,963 respectively. The provision will appear in the General Ledger as follows:

PROVISION FOR DISCOUNT RECEIVABLE

19—			19—		
June 30	To Profit and Loss A/c	128 8 0	June 30	By Balance, 2% on £6,420 c/d	128 8 0
19—			19—		
July 1	To Balance b/d	128 8 0	June 30	By Profit and Loss A/c	9 2 10
				Balance, 2% on £5,963 c/d	119 5 2
		£128 8 0			£128 8 0
19—					
July 1	To Balance b/d	119 5 2			

The provision will appear in the Balance Sheet as a deduction from Sundry Creditors, thus (at end of first year):

Sundry Creditors	6,420 0 0		
Less Provision for Discount	128 8 0	6,291 12 0	

The wisdom and propriety of taking credit for discounts receivable in advance of settlement of the creditors' accounts is a debatable matter.

Without attempting to marshal all the arguments for and against this practice it may be said:

(*a*) A Provision for Discounts Receivable should never be created unless provision is also being made for discounts allowable.

(*b*) The percentage at which the provision is calculated should not exceed the average rate that can be obtained if all the accounts are paid promptly (some of the balances may be net and not subject to cash discount).

(*c*) Unless the financial position of the business is such that it is reasonably certain that full advantage can be taken of the terms of discount no provision should be made. On the other hand, it will still be prudent to provide for discount allowable to customers.

REPAIRS AND MAINTENANCE EQUALIZATION RESERVES

The actual expenditure on repairs and maintenance of premises and plant may vary considerably from one year to another. Furthermore, in a year in which the plant is fully occupied and large profits are being made, the expenditure on maintenance may be small, as it will not be possible to lay up the machines for any length of time and only essential repairs can therefore be undertaken.

In another year, when there is not enough work to keep the machines fully occupied, advantage may be taken of this circumstance to undertake extensive overhauls. Consequently the charge for repairs may tend to be high in years in which the profits are low and vice versa, and the fluctuation in the profits is thus accentuated.

There is also the factor that new machinery does not normally require much expenditure on repair and replacement of small parts in the earlier years of its life, but at a later stage in its existence these charges may be heavy. Clearly, the early years which have received the full benefit of the use of the machinery ought to bear a due proportion of the eventual repair charges. This is particularly important when depreciation is being provided for by the straight-line or fixed instalment method, so that there is not a higher charge for depreciation in the early years to compensate for the small expenditure on repairs.

It is not essential, however, that the amount charged to Profit and Loss Account should represent the cost of repairs actually effected in the year under review. The annual charges can be equalized and provision made for accrued expenditure by the operation of a Repair and Maintenance Reserve (sometimes known as a Repairs Equalization Reserve or a Reserve for Deferred Repairs).

A similar procedure can be adopted to provide for accruing expenditure on repairs and decorations of buildings. This is particularly important where the trader holds his premises under a lease which imposes the obligation to repair and decorate at stated intervals.

Example

A trader holds a lease of premises under which he undertakes to do external repairs and decorations at the end of every five years and internal repairs and decorations at the end of every three years. The

premises were entirely redecorated at the landlord's expense before the trader took possession of them.

The estimated costs of carrying out these obligations are:

External repairs and decorations, every 5 years £300.
Internal repairs and decorations, every 3 years £200.

The total estimated expenditure over a period of 15 years will, therefore, be 3 × £300 = £900, plus 5 × £200 = £1,000, total £1,900. There will also be incidental expenditure from time to time and there may be a claim for dilapidations (the obligation to restore the premises to their original condition) at the end of the lease. It is therefore decided to provide an annual sum of £150 for the creation of a Premises Repairs Reserve.

The actual expenditure during the first four years of the lease was £20, £50, £30, £220. The Premises Repairs Reserve will operate as follows:

PREMISES REPAIRS RESERVE

			£				£
Year 1	To Sundries		20	Year 1	By Profit and Loss A/c		150
	Balance	c/d	130				
			£150				£150
Year 2	To Sundries		50	Year 2	By Balance	b/d	130
	Balance	c/d	230		Profit and Loss A/c		150
			£280				£280
Year 3	To Sundries		30	Year 3	By Balance	b/d	230
	Balance	c/d	350		Profit and Loss A/c		150
			£380				£380
Year 4	To Sundries		220	Year 4	By Balance	b/d	350
	Balance	c/d	280		Profit and Loss A/c		150
			£500				£500
				Year 5	By Balance	b/d	280

Alternatively, the expenditure actually incurred each year can be written off to Profit and Loss Account, and additional provision can be made by a transfer from Profit and Loss Account to a Deferred Repairs Reserve. This method is particularly appropriate when exceptional conditions (for example, during or following a war) make it impossible to carry out repairs on the normal scale and substantial expenditure will have to be incurred at a later date to make good the ravages of the past.

The principles developed in the preceding chapters in regard to trading concerns will now be applied in a more comprehensive example to a business which manufactures goods and then sells them to its customers. The starting point in this case will be a Trial Balance and it will have to be borne in mind that the Trading Account, which still fulfils the function of showing the gross profit made by the owner of the business when he sells the finished articles, will have to be debited with all costs directly incurred in purchasing raw materials and getting them into a condition in which they are ready for resale. Expenses incurred in selling the products of the business and the general administration expenses (known alternatively as overhead or establishment charges) will, as before, appear in the Profit and Loss Account.

For the benefit of students, an actual examination question set for the London Chamber of Commerce Certificate has been chosen.

The following balances appeared in the books of L. Timmins, trading as Timmins & Co., at December 31:

	£
L. Timmins, Capital	43,850
Freehold Land and Factory	8,000
Leasehold Premises	3,000
Plant and Machinery	7,500
Reserve for Bad and Doubtful Debts	450
Factory Wages and Salaries	21,000
Administration and other Salaries	3,000
Stocks at January 1:	
Raw Materials	1,500
Finished Goods	2,000
Work-in-progress at January 1	1,800
Fuel Stock at January 1 and purchases during the year	5,000
Purchases—Raw Materials	23,000
Sales	62,500
Rents, Rates and Taxes	1,300
Repairs and Renewals—Factory	1,000
,, ,, —General	250
Travellers' Expenses	1,750
Carriage Inwards	700
,, Outwards	1,100
Insurance	350
General Expenses	2,500
L. Timmins, Current A/c (Dr. Balance)	2,750
Bad Debts written off	150
Sundry Debtors	18,750
,, Creditors	3,360
Balance at Bank and Cash in Hand	3,760

Trading and Profit and Loss Account for year and a Balance Sheet

at December 31 are to be prepared, taking into account the following information:

Stocks at December 31 were:

	£
Work-in-progress	1,900
Raw Materials	1,600
Finished Goods	2,250
Fuel	300
Rates and Taxes paid in advance	100
Insurance paid in advance	45
General Expenses due but not paid were	165

Depreciation is to be provided for on Plant and Machinery at 10 per cent per annum and on Leasehold Premises £300.

The Reserve for Bad and Doubtful Debts is to be adjusted to 3 per cent of the total debtors.

Note. It was not strictly correct to say that the starting point is a Trial Balance; a list of balances is given and the student has first to decide which of the figures are debit balances and credit balances respectively. If time permits it will, therefore, be desirable to re-draft the data in the form of a proper Trial Balance, as follows:

	Dr. £	Cr. £
L. Timmins, Capital		43,850 (B)
Freehold Land and Factory	8,000 (B)	
Leasehold Premises	3,000 (B)	
Plant and Machinery	7,500 (B)	
Reserve for Bad and Doubtful Debts		450 (B)
Factory Wages and Salaries	21,000 (T)	
Administration and other Salaries	3,000 (P)	
Stocks at January 1:		
Raw Materials	1,500 (T)	
Finished Goods	2,000 (T)	
Work-in-Progress	1,800 (T)	
Fuel	5,000 (T)	
Purchases—Raw Materials	23,000 (T)	
Sales		62,500 (T)
Rents, Rates and Taxes	1,300 (P)	
Repairs and Renewals—Factory	1,000 (T)	
,, ,, —General	250 (P)	
Travellers' Expenses	1,750 (P)	
Carriage Inwards	700 (T)	
,, Outwards	1,100 (P)	
Insurance	350 (P)	
General Expenses	2,500 (P)	
L. Timmins, Current A/c	2,750 (B)	
Bad Debts	150 (P)	
Sundry Debtors	18,750 (B)	
,, Creditors		3,360 (B)
Balance at Bank and Cash in Hand	3,760 (B)	
	£110,160	£110,160

It will be noticed that each item has been marked as follows, according to its location in the final accounts: T = Trading Account, P = Profit and Loss Account, B = Balance Sheet.

As there are no appropriations of profit as distinct from expenses, an Appropriation Account does not arise. It will be seen later that the Trading Account of a manufacturing business is sometimes subdivided into Manufacturing Account and Trading Account, but that also does not arise here.

It does not follow because the items have been marked in this way that they will be dealt with, as indicated, without adjustment. Thus, the value of plant and machinery to be taken into the Balance Sheet will obviously be affected by the deduction of depreciation, and similar adjustments will affect many of the other items. The next step in the development of the answer is, therefore, to set out the adjustments in trial balance or journal entry form, as follows:

		£	£
Work-in-Progress		1,900 (B)	1,900 (T)
Raw Materials		1,600 (B)	1,600 (T)
Finished Goods		2,250 (B)	2,250 (T)
Fuel		300 (B)	300 (T)
Rates and Taxes paid in advance		100 (B)	100 (P)
Insurance paid in advance		45 (B)	45 (P)
General Expenses accrued		165 (P)	165 (B)
Depreciation—Plant and Machinery		750 (T)	750 (B)
" —Leasehold Premises		300 (P)	300 (B)
New Bad Debts Reserve	562 10 0		
Old Bad Debts Reserve	450 0 0		
Increase	£112 10 0 (say)	113 (P)	113 (B)

L. TIMMINS

Trading and Profit and Loss Account for the year ended December 31

	£	£		£	£
To Stocks, Jan. 1:			By Sales		62,500
Work-in-Progress	1,800		Stocks, Dec. 31:		
Finished Goods	2,000		Work-in-Progress	1,900	
		3,800	Finished Goods	2,250	
					4,150
Materials Consumed:					
Stock, Jan. 1	1,500				
Purchases	23,000				
Carriage Inwards	700				
	25,200				
Less Stock, Dec. 31	1,600				
		23,600			
Factory Wages and Salaries		21,000			
Fuel		4,700			
Factory Repairs and Renewals		1,000			
Depreciation of Plant and Machinery		750			
Gross Profit, carried down		11,800			
		£66,650			£66,650

	£		£
To Administration and other Salaries	3,000	By Gross Profit, brought down	11,800
Rents, Rates and Taxes	1,200		
Travellers' Expenses	1,750		
Carriage Outwards	1,100		
General Expenses	2,665		
Insurance	305		
Repairs and Renewals	250		
Bad Debts	150		
Bad Debts Reserve	113		
Depreciation of Leasehold Premises	300		
Net Profit, transferred to Capital Account	967		
	£11,800		£11,800

Note. It is not always easy to decide exactly what items ought to be charged in the Trading Account. Clearly the cost of materials purchased, with appropriate adjustments for the stocks on hand at the beginning and end of the year, must be so charged. Carriage *inwards* is normally regarded as part of the cost of these materials and is included on that ground. Carriage *outwards*, on the other hand, is usually regarded as a cost incurred in the process of selling the goods and is charged in the Profit and Loss Account with other selling expenses such as Travellers' Salaries and Expenses, Bad Debts and the like. If, however, the carriage charges are specifically recouped by the trader when he invoices his customers and are therefore included in the credit for sales in the Trading Account, carriage outwards ought also to be debited in that account.

Wages paid to workmen engaged in the factory in the process of turning the raw material into the finished article also represent a direct or manufacturing expense and are therefore charged in the Trading Account. This treatment is also extended to indirect wages and salaries, that is, payments to workmen whose work does not enter directly into the finished article (for example, storekeepers, crane drivers and watchmen) and payments to others who spend the whole of their time in the factory in a managerial capacity. These further amounts may not be expenses strictly chargeable to manufacturing processes but they are essentially costs incurred in the factory as distinct from the warehouse or office, and as such are regarded as part of the total cost of production.

As a logical development of this argument, Fuel, and Factory Repairs and Renewals, are also proper Trading Account charges. There may be room for some difference of opinion as to whether Depreciation of Plant and Machinery is also a Trading Account item, but modern opinion confirms this treatment of it. The use of machinery is frequently an alternative to the use of hand labour, and the charge for depreciation takes the place of the increased charge for wages that would otherwise have been incurred.

It has been assumed that the Leasehold Premises, as distinct from the Freehold Land and Factory, are used for office or warehousing purposes only. The charge for depreciation of this asset, therefore, appears in the Profit and Loss Account. In the absence of further information all the other expense items have been debited in the Profit and Loss Account, but it may be noted that

had the details been available, the following items might have given rise to further charges in the Trading Account:

Rent, Rates and Taxes—any rates and taxes applicable to the factory.

Insurance—any charge for employers' liability insurance or any other insurance that varies directly with the volume of work done.

General Expenses—any expenses included therein that arise directly from the manufacturing operations.

When considering the Trading Account, particular attention should be paid to the setting out of the item Materials Consumed. The adjustments for opening and closing stocks are shown on the face of the account, as these stock figures will be of material interest to the trader. The adjustment for closing stock of fuel is not shown similarly; the value of the opening stock has become merged with purchases of fuel in one figure in the Trial Balance, so there is no point in showing the adjustment for closing stock.

With this form of Trading Account, stocks of finished goods and of work-in-progress are merely adjustments necessary to arrive at the true gross profit on goods sold during the year; they are, therefore, grouped together. In the alternative form of Manufacturing Account on page 124 they call for different treatment.

L. TIMMINS

Balance Sheet as at December 31

	£	£		£	£
L. Timmins, Capital A/c:			Freehold Land and Factory		8,000
Balance at Jan. 1	43,850		Leasehold Premises	3,000	
Add Net Profit for year ended Dec. 31	967		*Less* Depreciation written off	300	
	44,817				2,700
Less Drawings	2,750		Plant and Machinery	7,500	
		42,067	*Less* Depreciation written off	750	
Sundry Creditors:					6,750
Trade	3,360		Stocks:		
Accrued Expenses	165		Raw Materials	1,600	
		3,525	Fuel	300	
			Work-in-Progress	1,900	
			Finished Goods	2,250	
					6,050
			Sundry Debtors:		
			Trade	18,750	
			Less Bad Debts Reserve	563	
				18,187	
			Payments in Advance	145	
					18,332
			Cash at Bank and in Hand		3,760
		£45,592			£45,592

Note. In the setting of the Balance Sheet it will be noticed that the assets are arranged in a logical sequence, commencing with the most permanent item, Freehold Premises, and finishing with the most liquid, Cash. As much detail as is useful is given but items that are of precisely the same nature (such as the two payments in advance) are shown in total. Payments in advance are not

debts due to the trader in the strict sense; nevertheless they are usually grouped under the general heading of Sundry Debtors. The increase in the Bad Debts Reserve is, of course, calculated on the trade debts alone.

As Timmins is a sole trader it is assumed that the separate Current Account in his name which appears in the Trial Balance is merely for the purpose of recording his drawings for the year. The Current Account is, therefore, closed on December 31 by transfer to the Capital Account.

Although not specifically called for by the terms of this question, an alternative rendering of part of the answer in the form of separate Manufacturing and Trading Accounts may be of interest:

Manufacturing Account for the year ended December 31

	£	£		£
To Materials Consumed:			By Cost of Production, carried to Trading A/c	50,950
Stock at Jan. 1	1,500			
Purchases	23,000			
Carriage Inwards	700			
	25,200			
Less Stock Dec. 31	1,600			
		23,600		
Factory Wages and Salaries		21,000		
Fuel		4,700		
Factory Repairs and Renewals		1,000		
Depreciation of Plant and Machinery		750		
		51,050		
Add Work-in-Progress, January 1		1,800		
		52,850		
Less Work-in-Progress December 31		1,900		
		£50,950		£50,950

Trading Account for the year ended December 31

	£		£
To Stock, January 1	2,000	By Sales	62,500
Cost of Production	50,950		
	52,950		
Less Stock, December 1	2,250		
	50,700		
Gross Profit, carried to Profit and Loss Account	11,800		
	£62,500		£62,500

QUESTIONS AND EXERCISES

(Key to answers on page 570.)

(1) The following particulars relate to stationery and stamps used in a business:

	£	s.	d.
Total cash paid, year to December 31, 1948	226	17	10
" " " " " " " 1949	172	0	8
Stock on hand, December 31, 1947	17	6	6
" " " " " 1948	34	9	3
" " " " " 1949	29	11	9
Amounts owing, 1947	27	3	8
" " 1948	36	14	9
" " 1949	46	13	0

Write up the Stationery and Stamps Account for each of the two years ended December 31, 1948 and 1949, and state what would have been the effect if in listing the amounts owing as on December 31, 1948, an item of £7 5s. had been omitted. (*Chartered Accountants, Inter.*).

(2) On July 1, 1948, AB entered into tenancy of XY's warehouse at £160 per annum, payable £40 per quarter at the end of each three months. On October 1, 1948, he sub-let part to CD at £24 per half-year (payable in advance) and on December 1, 1948, another part to EF at £12 per quarter (payable at the end of each three months thereafter).

AB maintains one account only for rent (that is, both receivable and payable). You are required to give this account as it would appear in the ledger for the period July 1, 1948, to December 31, 1949. The transactions are as under:

			£
1948			
Oct.	2	Received from CD	24
Oct.	10	Paid to XY	40
Dec.	31	Prepared Profit and Loss Account for the year 1948	
1949			
Jan.	3	Paid to XY	40
March	6	Received from EF	12
April	4	Paid to XY	40
April	5	Received from CD	24
June	7	Received from EF	12
July	3	Paid to XY	40
Sept.	4	Received from EF	12
Oct.	3	Received from CD	24
Oct.	10	Paid to XY	40
Dec.	3	Received from EF	12
Dec.	31	Paid to XY	40
Dec.	31	Prepared Profit and Loss Account for the year 1949	

(*Inst. of Bankers, Part I*).

(3) At December 31 the ledger of T. Atkins contained the following balances for debts due to him:

	£	s.	d.
Arthur	36	1	8
Charles	15	10	0
Henry	14	1	10
Percy	20	10	0

The estate of Arthur is being administered in bankruptcy, and it is feared, pending realization, that not more than 10s. in the £ will be recoverable. Henry has died and his estate has no assets whatever. For the sake of prudence 5 per cent is to be reserved on the debts of Charles and Percy.

Show the four accounts, together with Bad Debts Account and Reserve for Doubtful Debts Account. Journal need not be given.

(*Inst. of Bankers, Part I*).

(4) N. Carlisle, a property owner, entrusts his rent collection and management of his property to R. Slessor, an agent, who renders half-yearly accounts. Following the end of the half-year ended December 31, 1948, the agent sends N. Carlisle a cheque for £325 0s. 8d., together with the following statement:

	£	s.	d.	£	s.	d.
Rents collected for the half-year ended December 31, 1948				585	11	3
Payments:						
Rates for the half-year ended March 31, 1949	105	2	6			
Water Rate for half-year ended December 31, 1948	15	18	6			
Ground Rent for the half-year ended December 31, 1948	57	10	0			
Commission on rent collected	29	5	6			
Repairs	40	11	7			
Insurance for year ended March 31, 1949	12	2	6			
				260	10	7
				£325	0	8

Prepare journal entries for recording the above particulars fully in N. Carlisle's books, with the necessary adjustments for the half-year's final accounts. (*L.C. of C. Certificate*).

(5) L. Bullivant extracted his Trial Balance at September 30 and found that credits exceeded debits by £27 7s. 8d. He debited a Suspense Account with this difference and proceeded with the preparation of his final accounts.

(*a*) How would you deal with the balance of the above Suspense Account when drafting the final accounts?

(*b*) Before finally closing his books, Bullivant discovered that the difference was due to the following errors:

(i) Drawings £45 had been entered correctly in the Cash Book but posted to Drawings Account as £54.

(ii) A total in the Purchases Book had been carried forward as £1,678 9s. 8d. instead of £1,679 8s. 8d.

(iii) A discount allowed to R. James, £3 10s., had not been entered in the Cash Book but James's debit had been written off in full in the ledger.

(iv) Depreciation on motor vans, £84, had been entered correctly in the Motor Vans Account but entered in Depreciation Account as £48.

(v) The credit balance of L. Rust's Account had been brought down as £40 6s. 8d. instead of £46 8s.

Show the entries now necessary to correct the above errors.

(*c*) State how each of the above errors would affect the figure of net profit already ascertained by Bullivant. (*L.C. of C. Certificate*).

(6) A business prepares accounts annually to October 31 and stocktaking takes place during the following week-end.

On one occasion, October 31 fell on a Wednesday, stocktaking commenced on November 3 and the value of stock then actually on the premises was found to be £15,918 17s. 4d. You ascertain the following additional facts:

(*a*) Goods outwards are entered in the Sales Day Book as on the day of dispatch.

(*b*) Goods inwards are entered in the Bought Day Book as on the date of the invoice.

(*c*) Sales during the period November 1–3 as shown by the Sales Day Book and the Cash Sales Book amounted to £195 8s. 4d.

(*d*) Purchases during the same period as shown by the Bought Day Book amounted to £151 2s. 6d., but, of these, goods to the value of £53 13s. 9d. were not received until after November 3.

(*e*) Goods invoiced during October and not received until November totalled £160 0s. 6d. Of these, goods to the value of £130 15s. were actually received during the period November 1–3 and £29 5s. 6d. after November 3.

(*f*) The average ratio of gross profit to turnover is 28 per cent.

You are instructed to ascertain the value of the stock as on October 31 for inclusion in the year's accounts, on the assumption that the Purchases Account is not to be adjusted. (*Chartered Accountants, Inter.*).

(7) The following is the Trial Balance extracted from the books of A. Goodchild, a merchant, on December 31, 1948:

	Dr.	Cr.
Goodwill	1,500	
Capital account		6,000
Current account, December 31, 1947		2,581
Drawings	1,076	
Freehold Premises	2,000	
Motor Vehicles:		
Purchased January 1, 1948	450	
,, February 28, 1948	300	
Repairs to premises	191	
Stock, December 31, 1947	4,500	
Purchases	7,375	
Sales		14,897
Wages	1,317	
Salaries	300	
Motor Vehicle Running Expenses	284	
Rates	125	
Insurance—fire, etc.	67	
Office Expenses	381	
Sales Ledger balances	1,291	
Bought Ledger balances		1,892
Balance at Bank	1,578	
Deductions from employees' wages for Savings Certificates		145
Savings Certificates purchased for employees	300	
Purchase Tax	2,375	
Professional Charges	105	
	£25,515	£25,515

You are required to prepare Trading and Profit and Loss Accounts for the year to December 31, 1948, and Balance Sheet as on that date, after taking into account the following information and instructions:

(*a*) Make provision for the following accrued expenses:
Wages £35
Motor Vehicle Running Expenses £187
Office Expenses £17.

(*b*) Depreciate motor vehicles at the rate of 20 per cent per annum.

(*c*) Stock on hand at December 31, 1948, was valued at £2,800.

(*d*) Stock, value £875, was destroyed by fire during the year; the claim was settled and paid in full on February 10, 1949, by the insurance company.

(*e*) Provide £600 for taxation.

(*f*) Rates paid in advance at December 31, 1948, amount to £25.

(*Chartered Accountants, Inter.*).

(8) The following balances appeared in the books of a manufacturer at December 31:

	£
Proprietor's Capital	57,500
Freehold Land and Factory at cost	18,000
Leasehold Premises	3,500
Plant and Machinery at cost less Depreciation	17,500
Reserve for Bad and Doubtful Debts	500
Factory Wages and Salaries	28,000
Administration and other Salaries	3,000
Stock at January 1,	
Raw Materials	1,500
Finished Goods	2,000
Work-in-Progress, January 1	1,800
Fuel—Stock at January 1, and Purchases during the year	6,000
Purchases—Raw Materials	29,000
Sales	88,000
Rent, Rates and Taxes	1,400
Repairs and Renewals (Factory)	1,100
,, ,, ,, (General)	250
Travellers' Expenses	1,750
Carriage Inwards	900
Carriage Outwards	1,100
Insurance	350
General Expenses	2,500
Proprietor's Current Account (Dr. Balance)	2,750
Bad Debts written off	190
Sundry Debtors	25,000
Sundry Creditors	4,500
Balance at Bank and Cash in Hand	2,910

The following stocks, etc., were held at December 31:

	£
Work-in-Progress	2,100
Raw Materials	1,750
Finished Goods	2,400
Fuel	350

Rates and Taxes paid in advance amounted to £100 and insurance paid in advance £50. General Expenses due but not paid were £180. Depreciation is to be provided on Plant and Machinery at the rate of 10 per cent on the balance shown, and a sum of £350 is to be written off the leasehold premises. The Reserve for Bad and Doubtful Debts is to be adjusted to 3 per cent on the Sundry Debtors.

From the foregoing figures you are required to prepare:

(*a*) Manufacturing Account;

(*b*) Trading and Profit and Loss Account; and

(*c*) Balance Sheet at December 31. (*Chartered Accountants, Inter.*).

CHAPTER VIII

PARTNERSHIP LAW

If two or more persons carry on a business in common and do not for that purpose form a company under the Companies Acts or obtain some other form of incorporation, they are said to be partners. The law of partnership governs their relations with each other and with others with whom they have dealings. This law is found, for the most part, in the Partnership Act, 1890, which merely codified the previously existing common law on the subject.

Some knowledge of the general principles of contract law is necessary for a proper understanding of partnership, and in practice legal advice will usually be taken both in forming a partnership and when legal problems arise in the conduct of it. The purpose of this chapter is to give a general outline of the law, more particularly as it affects financial transactions of, and between, the partners and the correct recording of those transactions in the books of account.

GENERAL CONSIDERATIONS

The most important point always to be remembered is that in England a partnership (commonly referred to as a firm) has no existence or legal entity distinct from that of the partners who compose it. Consequently, each partner is liable to the full extent of his private resources, if necessary, to answer for the debts and obligations of the firm. Further, every partner normally has the right to participate actively in the conduct of the partnership business (unless he has specifically contracted out of this right), and in doing so will incur on behalf of the firm obligations for which his co-partners will be jointly liable with himself.

On the other hand, all partners are usually entitled to share in the profits arising from the partnership business. The nature of a partner's interest in the firm is thus a mixture of rights and obligations. There is perhaps some tendency for partnerships to be entered into in anticipation of substantial profits and benefits without sufficient recognition of the obligations and liabilities that will thereby be undertaken.

It is not essential that any formal legal agreement should be signed in order to constitute a partnership; its existence may sometimes be inferred from the conduct of the persons who are carrying on a business. This sometimes results in the possibility of a person who permits himself to share in the profits of a business being held liable as a partner and made responsible for the whole of the liabilities of the firm without ever having entered into a partnership agreement. It is clearly desirable that:

(1) intending partners should enter into a proper agreement defining their rights and obligations, and

(2) proper books of account should be kept, recording the interests of the individual partners in the firm, as well as the assets and liabilities of the business.

The main headings of a partnership agreement are considered later in this chapter, and the next two chapters deal fully with the book-keeping records.

Where there is no written partnership agreement, but a partnership does in fact exist, there must be deemed to be an agreement between the parties, and its terms will, as far as possible, be implied from their acts. In such a case the entries in the books, particularly when incorporated in a Profit and Loss Account and Balance Sheet at the end of a period of trading, and agreed (or not disputed) by the partners, may be of great importance in establishing the existence of an implied agreement.

All legal contracts require the contracting parties to act towards each other in good faith. A partnership agreement, whether express or implied, is no exception to this rule, but in fact goes further. Partnership is one of a limited number of types of contract that require the utmost good faith to be observed by all the parties.

Until the growth of the joint-stock company system in the middle of the nineteenth century a partnership was the usual form of association between persons who wished to carry on a business jointly. The growth of industry and commerce, the size of businesses involved and, in particular, the large amount of capital that had to be raised to enable certain new forms of enterprise such as railway companies to be launched, led to the development of the company system and thus provided an alternative to partnership. This process became particularly noticeable when, in 1908, it first became possible to form a limited company with as few as two members (see Chapter XI).

It might have been thought that this eventually would have led to the complete disuse of the partnership system; that it has not done so is probably due primarily to the privacy of a partnership as compared with a company incorporated under the Companies Acts. The formation of a partnership is a private matter between the parties concerned; there is no Registrar of Partnerships, for no registration is required except to a limited extent under the Registration of Business Names Act.

Further, the affairs of a partnership can be conducted with complete informality; there is no obligation to hold annual or other meetings or to render annual returns to a Registrar. Finally, the expression business includes most of the professions, which cannot normally be carried on with limited liability and for which a partnership is the only appropriate form of association.

The following outline of the law of partnership is based primarily on the provisions of the Partnership Act, 1890, to which the sections quoted belong, unless the contrary is indicated in the text.

DEFINITION OF PARTNERSHIP

"Partnership is the relation which subsists between persons carrying on a business in common with a view of profit" (S.1). Companies registered under the Companies Acts or other Acts of Parliament, or associations constituted by letters patent or Royal Charter, are, however, excepted from this definition.

It will be noticed that there is no definition of a partnership as such.

The fact that a firm has no separate existence is thus recognized. Partnership is the relationship between persons—not the persons themselves.

For the purpose of the definition of partnership the expression business "includes every trade, occupation or profession." This is very wide in its scope, but is qualified by the condition that it must be carried on *in common*, with a view of *profit*. The intention to share profits is normally the primary reason for entering into a partnership, these profits being such as arise from the carrying on of a business and not merely income arising from the joint ownership of property. The expression profit means net profit; the sharing of gross returns is not essentially an incident of partnership, but merely indicates joint ownership (for example, persons who jointly own a house and share the rent are not normally partners).

THE FIRM NAME

"Persons who have entered into partnership with one another are for the purposes of this Act called collectively a firm and the name under which their business is carried on is called the firm name" (S.4).

The use of a firm name is merely for the convenience of the partners in acting collectively. In England it does not bring into being a separate legal entity, although in Scotland, where the law is different, it does. The firm name need not include the names of all the partners, nor, for that matter, of any of them. Thus, Smith and Jones, as partners, might trade as Robinson & Co., or even as J. Robinson, and might very well do so if they had taken over a business formerly carried on by J. Robinson. They must not, however, adopt the name of an existing firm for the purpose of passing themselves off as being that firm.

Although the Partnership Act does not require registration of a partnership as such, the Registration of Business Names Act, 1916, does require that any business name "which does not consist of the true surnames of all partners who are individuals and the corporate name of all partners who are corporations, without any addition other than the true Christian names of individual partners or initials of such Christian names," must be registered with the Registrar of Business Names.

Thus, if William Smith and Harold Jones trade in partnership as William Smith & Harold Jones or as W. Smith & H. Jones, or even as Smith & Jones, they are not required to register under the Registration of Business Names Act. If, however, they trade as J. Robinson or as Robinson & Co., or even as Smith, Jones & Co., or Smith & Partner, then registration is required. Where the firm name is an impersonal one, such as The Z Manufacturing Co., registration is always required.

The Registration of Business Names Act has to some extent fallen into disuse. The Register cannot be regarded as a complete record of all existing partnerships, for some firms are exempt from registration and many others that ought to register do not in fact do so.

LIMITATION OF NUMBER OF PARTNERS

Although the Partnership Act does not appear to contemplate any limit to the number of persons who can constitute a partnership, it is generally not desirable that a large number of persons should use this

form of business association. A limit is in fact fixed by the Companies Acts, whereby it is provided that it is illegal for any association of more than twenty persons to exist for the purpose of carrying on a business unless registered under the Companies Act or some other Act.

A partnership may be governed by an Act (the Partnership Act, 1890), but it is not registered under that Act. The maximum number of partners in one firm is therefore effectively limited to twenty, unless the business carried on is that of banking, when a limit of ten is fixed.

DETERMINING THE EXISTENCE OF A PARTNERSHIP

Where a proper partnership agreement has been entered into at the outset there will normally be no difficulty in determining who are partners. In other cases there will generally be little difficulty in determining, as between the partners themselves, who those partners are; but creditors may find it more difficult to establish the full membership of the firm.

For this reason the Partnership Act lays down certain rules which, while confirming that "the sharing of gross returns does not of itself create a partnership," provide that "the receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner in the business" (S.2). The sharing of profits being *prima facie* evidence of partnership does not mean that it constitutes a partnership in itself, but as a general rule if a person shares in the net profits of a business the onus will be upon him to show that in fact he is not a partner. There are five exceptions to this rule, namely:

(1) The receipt of a debt by instalments;
(2) Remuneration of an employee;
(3) An annuity to the widow or child of a deceased partner;
(4) Interest on a loan, provided there is a written agreement;
(5) Payments for the sale of the goodwill of a business;

which, even though they take the form of a share of profits, do not thereby constitute the recipient a partner in the business carried on by the payer, or liable as such. Of course, in such cases the recipient of the share of profits might still be held to be a partner if there were other facts to warrant that conclusion.

The importance of these rules lies in the liability of all the partners to answer for the debts of a firm. If the business carried on is successful the liabilities to creditors will normally be met out of the business assets, but should losses be incurred, or the partnership assets be dissipated in some way (for example, by one partner withdrawing an excessive amount from the firm), then the available assets may be insufficient to meet debts. The personal liability of the partners then comes into the picture, and as some of the partners may be without any personal assets or resources, it may be of importance to creditors to establish that some other person of substance is in fact a partner and liable as such.

LIABILITY OF PARTNERS

A creditor who cannot obtain settlement of his account can normally only enforce payment by invoking the process of law. The person who is indebted to the creditor is then sued (normally either in the County Court

or in the High Court, according to the amount of the debt), and if the Court finds the claim to be well founded it will deliver judgment against the defendant. When the debtor is a sole trader this is a comparatively simple matter and the judgment will be against him and him alone.

A creditor who wishes to enforce payment by a partnership, however, has to recognize that in England the firm itself is not a person. He must, therefore, sue the individual partners. It is true that the action may be brought against them in the firm name, but even so it is the partners who, ultimately, will be personally liable.

The liability of partners for ordinary contract debts (such as for cost of goods bought by the firm) is said to be joint. This means that the creditor can bring one action against one, some or all of the partners. He is not bound to sue them all (he may not be aware of the existence of some of them), but if he does not sue all he cannot commence another action in respect of the same debt even though the original judgment remains unsatisfied.

JOINT AND SEVERAL LIABILITY

In some instances, however, partners may become *jointly and severally* liable for the obligations of the firm. When simple contracts are involved this will arise only if the partners have agreed to be so liable (for example a bank might advance money on overdraft to a firm, but the written agreement signed by all of them, under which the advance is made, might stipulate that the partners are to be jointly and severally liable). An exception to this is found in the rule that the estate of a deceased partner is severally liable for the debts incurred before the death of that partner.

Joint and several liability also arises in respect of *torts* (that is, civil wrongs actionable at law) committed in the course of a partnership business, as, for example, where the partners in one firm bribed an employee in another firm to betray to them confidential information. In suitable cases damages will be awarded against the partners, and for these their liability will be joint and several. Also, where "(*a*) one partner acting within the scope of his apparent authority receives the money or property of a third person and misapplies it; and (*b*) a firm in the course of its business receives money or property of a third person, and the money or property so received is misapplied by one or more of the partners while it is in the custody of the firm" (S.11), all the partners are jointly and severally liable to the person who has suffered loss.

Joint and several liability is wider than joint liability. The fact that judgment has been obtained against some only of the partners will be no bar to a further action if the liability is joint and several. A further action might therefore be commenced at a later date against a person who was not originally known to be a partner, if judgment under an earlier action against the other partners remains unsatisfied.

Before a third party can succeed in any action against the members of a firm, however, it may be necessary to show that the contract or tort in respect of which the claim arises is one for which all the partners might properly be held liable.

"Every partner is an agent of the firm and his other partners for the purpose of the business of the partnership; and the acts of every partner who does any act for carrying on in the usual way business of the kind carried on by the firm of which he is a member bind the firm and his partners, *unless* the partner so acting has in fact no authority to act for the firm in the particular matter, and the person with whom he is dealing either knows that he has no authority, or does not know or believe him to be a partner" (S.5).

This important provision illustrates the fundamental nature of partnership. An agent is a person who has power, on behalf of another person, his principal, to enter into contracts with third parties (who may or may not at that time be aware of the existence of the principal) by which the principal will be bound. Partnership is a special form of agency in that every partner is both an agent and a principal; an agent in the sense that he has power to bind his co-partners; a principal in that he may in turn be bound by their actions.

As already stated, a partner may contract out of his power to participate actively in the management of the firm, but if such a person, in breach of this agreement, does in fact participate in the conduct of the business and enters into contracts or does "any act for carrying on in the usual way business of the kind carried on by the firm," the firm will still be liable unless it can be shown that the person claiming either was at the particular time aware of this restriction in the partnership agreement or did not know that he was in fact dealing with a firm.

In other words, although the partnership agreement may restrict the authority of one or some of the partners, that restriction will be inoperative in regard to any person who is unaware of it. As partnership agreements are not usually open to inspection, a third party would not normally have any knowledge of this restriction unless steps had been taken to bring it to his notice.

Section 8 of the Act reinforces this point and places it beyond doubt: "If it has been agreed between the partners that any restriction shall be placed on the power of any one or more of them to bind the firm, no act done in contravention of the agreement is binding on the firm with respect to persons having notice of the agreement."

It will be noticed that the sections quoted do not attempt to lay down rules for establishing what acts may be regarded as done in "carrying on in the usual way business of the kind carried on by the firm." This will naturally depend to a certain extent on the nature of the partnership business. To buy jewellery on credit would be usual in a jeweller's business, but not in any other trade. As a result of many cases decided in the Courts it is generally accepted that the following acts are to be regarded as usual and will bind the firm:

(1) Selling goods belonging to the firm.

(2) Purchasing goods of a kind usually employed in the business.

(3) Receiving payment of debts and giving receipts therefor.

(4) Engaging employees.

If the partnership is engaged in *trade*, the following acts, in addition to the foregoing, come within the same category:

(5) Accepting and transferring negotiable instruments in the firm name.

(6) Borrowing money on the credit of the firm.

(7) Pledging goods and chattels of the firm.

(8) Making equitable mortgages of real or leasehold property (but not the creation of a legal mortgage which would require the execution of a deed, in which all partners must join. An equitable mortgage normally arises when deeds are deposited as security without any formal mortgage deed being signed).

All these acts are said to be within the implied authority of a partner.

Although in one case noted above which does not fall within this implied authority (the making of a legal mortgage) the firm will not be bound unless all the partners join in the act, it does not by any means follow that all acts that are not within these implied powers require the combined action of all the partners. A partner may have express authority from his co-partners to undertake transactions that would not be within his implied authority, and in the same way agents or employees who are not partners may nevertheless have express power to act on behalf of the firm.

"An act or instrument relating to the business of the firm and done or executed in the firm name, or in any other manner showing an intention to bind the firm, by any person thereto authorized, whether a partner or not, is binding on the firm and all the partners, *provided that* this section shall not affect any general rule of law relating to the execution of deeds or negotiable instruments" (S.6).

Where a partner acts in excess of his authority and a creditor is unable to hold the firm liable, that partner will, of course, be personally liable.

HOLDING OUT

"(1) Every one who by words spoken or written or by conduct represents himself, or who knowingly suffers himself to be represented, as a partner in a particular firm, is liable as a partner to any one who has on the faith of any such representation given credit to the firm, whether the representation has or has not been made or communicated to the person so giving credit by or with the knowledge of the apparent partner making the representation or suffering it to be made" (S.14(1)).

The action of a person who, in the way shown above, may become liable as a partner (although in fact he is not a partner and not entitled to the benefits of partnership) is known as holding out. This is an application of the doctrine of *estoppel*, whereby a person who by words or conduct has led another to believe in the existence of a certain state of affairs cannot, in defence to a claim by that other, deny the existence of the facts in which he led the other to believe.

It will be noted that the person who is made liable under this section need not necessarily have made any statement himself; he may be liable if he was aware that the statement was made by another and did not deny it. It is necessary, however, that credit should have been given to the firm on the faith of the representation.

"(1) A person who is admitted as a partner into an existing firm does not thereby become liable to the creditors of the firm for anything done before he became a partner.

"(2) A partner who retires from a firm does not thereby cease to be liable for partnership debts or obligations incurred before his retirement.

"(3) A retiring partner may be discharged from any existing liabilities by an agreement to that effect between himself and the members of the firm as newly constituted and the creditors, and this agreement may be either express or inferred as a fact from the course of dealing between the creditors and the firm as newly constituted" (S.17).

These provisions represent an obvious application of the principles already considered. An incoming partner is not liable for debts incurred before he was a partner, because the creditors clearly did not give credit in the knowledge or belief that he would be answerable for those debts.

On the other hand, an outgoing partner remains liable for debts incurred when creditors were able to look to him as one of the responsible partners. The terms of the partnership dissolution under which he leaves the firm may purport to relieve him of these liabilities, but such an agreement will not bind the creditors unless they were parties to it.

An agreement between the retiring partner, the continuing partners and a creditor, by which the latter releases the retiring partner, is known as a contract of novation. As there are of necessity three parties to it, it is also known as a tripartite agreement. Under such an agreement an incoming partner may agree to become liable for existing liabilities, for which he would not otherwise have been responsible.

The liability of an outgoing partner may extend beyond debts incurred before his retirement: "(1) Where a person deals with a firm after a change in its constitution he is entitled to treat all apparent members of the old firm as still being members of the firm until he has notice of the change" (S.36(1)).

The liability of the partner while he was a member of the firm arose under the agency of his co-partners, for which he, jointly with them, was liable as a principal. The principle of agency applies until third parties have had notice of its termination. Death, however, automatically determines an agency; the estate of a deceased partner is therefore relieved from liability for debts incurred after the date of that partner's death (but not, of course, for debts incurred before that date).

In order to protect a retiring partner from continuing liability it is necessary (1) to advertise the change in the constitution of the firm by an announcement in the *London Gazette*; and (2) to circularize persons who have had dealings with the firm in the time during which the retiring partner was known to such persons to have been a partner.

VARIATION OF PARTNERSHIP AGREEMENT

"The mutual rights and duties of partners, whether ascertained by agreement or defined by this Act, may be varied by the consent of all the partners, and such consent may be either express or inferred from a course of dealing" (S.19).

This power of variation applies only to the *mutual* rights and duties of partners; it cannot affect their relations with third parties. The reference to rights and duties "defined by this Act" applies mainly to the provisions of Section 24, which defines the rights and duties of the partners in regard to division of profits and similar matters where they have not been agreed upon by the partners.

SHARING PROFITS

Subject to agreement to the contrary (which agreement may be express or implied), Section 24 provides:

"(1) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses whether of capital or otherwise sustained by the firm.

"(3) A partner making for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of five per cent per annum from the date of payment or advance.

"(4) A partner is not entitled, before the ascertainment of profits, to interest on capital subscribed by him.

"(6) No partner shall be entitled to remuneration for acting in the partnership business."

RIGHTS OF PARTNERS

The other provisions of Section 24 are of a more general nature:

"(5) Every partner may take part in the management of the partnership business.

"(2) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him—(*a*) in the ordinary and proper conduct of the business of the firm, or (*b*) in or about anything necessarily done for the preservation of the business or property of the firm.

"(7) No person may be introduced as a partner without the consent of all existing partners.

"(8) Any difference as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners.

"(9) The partnership books are to be kept at the place of business of the partnership (or the principal place if there is more than one) and every partner may, when he thinks fit, have access to and inspect and copy any of them."

Section 25 provides that "no majority of the partners can expel any partner unless a power to do so has been conferred by express agreement between the partners."

DUTIES OF PARTNERS

The duties of partners as defined by the Act are principally based on the doctrine of *utmost good faith*, which is an indispensable condition of any partnership agreement.

"Partners are bound to render true accounts and full information of all things affecting the partnership to any partner or his legal representatives" (S.28).

"(1) Every partner must account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership, or from any use by him of the partnership property, name, or business connection.

"(2) This section applies also to transactions undertaken after a partnership has been dissolved by the death of a partner, and before the affairs thereof have been completely wound up, either by any surviving partner or by the representative of the deceased partner" (S.29).

"If a partner, without the consent of the other partners, carries on any business of the same nature as and competing with that of the firm, he must account for and pay over to the firm all profits made by him in that business" (S.30).

Partnership property, to which reference is made above (S.29), is defined as follows: "(1) All property and rights and interest in property originally brought into the partnership stock or acquired, whether by purchase or otherwise, on account of the firm, or for the purposes and in the course of the partnership business, are called in this Act partnership property, and must be held and applied by the partners exclusively for the purposes of the partnership and in accordance with the partnership agreement."

DURATION OF PARTNERSHIP

A partnership can be entered into either for a fixed or indefinite term. A fixed term is usually, but not necessarily, a period of so many years. It may, however, be for the duration of some venture or commercial undertaking (for example, to share in the profits of a certain voyage of a ship). Alternatively, it might be entered into for the joint lives of the partners. It may be noted that however definite the original agreement may be as to the duration of the partnership, if *all* the partners so agree it may be brought to an end at any time.

If there is no agreement as to the term, then the partnership is said to be a *partnership at will.* Such a partnership can be terminated at any time by any one of the partners giving notice to that effect to the others.

Many partnerships are initially entered into for a fixed term of years but on the expiration of that term are continued without a new agreement, thus becoming partnerships at will.

DISSOLUTION OF PARTNERSHIP

The various ways in which a partnership can be terminated may be summarized as follows:

(1) If it is a partnership at will, by any one of the partners giving notice to the others.

(2) By expiration of the term agreed upon, unless continued thereafter as a partnership at will.

(3) By the death or bankruptcy of any one of the partners, unless there is an agreement to the contrary.

(4) At the option of the other partners, if one of them allows his share in the partnership to be charged for his separate debt.

(5) By the happening of any event which would make the continuance of the partnership illegal.

(6) At any time and for any reason if *all* the partners so agree.

(7) The Court may decree a dissolution of the partnership:

(*a*) In the event of the lunacy of one of the partners.

(*b*) When a partner becomes incapable of carrying out his part of the agreement.

(*c*) When a partner is guilty of conduct prejudicial to the carrying on of the partnership business.

(*d*) When a partner wilfully or persistently commits a breach of the partnership agreement.

(*e*) When the business can only be carried on at a loss.

(*f*) When, in the opinion of the Court, it is just and equitable that the partnership be dissolved.

The sections of the Act dealing with the application of the assets of the partnership are almost entirely matters of accounting and are, therefore, considered in Chapter X.

RETURN OF PREMIUM

"Where one partner has paid a premium to another on entering into a partnership for a fixed term, and the partnership is dissolved before the expiration of that term otherwise than by the death of a partner, the Court may order the repayment of the premium, or of such part thereof as it thinks just, having regard to the terms of the partnership contract and to the length of time during which the partnership has continued, unless (*a*) the dissolution is, in the judgment of the Court, wholly or chiefly due to the misconduct of the partner who paid the premium, or (*b*) the partnership has been dissolved by an agreement containing no provision for a return of any part of the premium" (S.40).

This subject is largely bound up with the treatment of goodwill, which may be one of the partnership assets. The valuation of goodwill and the book-keeping entries that arise in regard thereto are considered in Chapters IX and X.

PARTNERSHIP AGREEMENT

Whether the partnership agreement is merely a written memorandum or a formal deed (generally known as Articles of Partnership) the following matters should be considered by the prospective partners and incorporated in the agreement:

(1) The name in which the business is to be carried on and the principal place of business.

(2) The amount of capital to be brought in by each partner.

(3) The basis of division of profits, including provision for interest on capital and partners' salaries, if so desired.

(4) The amount each partner is to be entitled to draw out of the business in anticipation of his share of profits.

(5) Provision for keeping proper books of account and for annual

accounts to be drawn up, to be audited and then signed by all the partners, after which they are to be binding upon them.

(6) The basis of valuation of goodwill for the purpose of any change in the partnership.

(7) The term of the partnership, if entered into for a fixed term.

(8) The basis upon which the amount due to a deceased or retired partner is to be calculated and how payment is to be made.

Other clauses will deal with any special points arising from the nature of the business or the wishes of the partners. In particular, if the business is to be managed by some of the partners, others not taking an active interest in the conduct of the firm, the respective rights and duties of the partners should be defined. Legal advice should always be taken on the drafting of a Deed of Partnership.

LIMITED PARTNERSHIP

Limited partnership was made possible by the Limited Partnerships Act, 1907. The main provisions governing a limited partnership are:

(1) It may not consist of more than ten partners in the case of a banking business, or more than twenty in the case of other concerns.

(2) It must contain one or more general partners liable for all debts and obligations of the firm, plus one or more limited partners.

(3) The limited partners must contribute agreed amounts of capital, which cannot be withdrawn during the existence of the partnership. Their liability is limited to the amount of such capital.

(4) The limited partners must not participate in management and their death, lunacy or bankruptcy does not automatically cause dissolution of the partnership.

(5) Such partnerships must be registered.

Few limited partnerships have been formed, mainly because the Companies (Consolidation) Act, 1908, and subsequent Acts made it possible to form limited companies with as few as two members and offered equal or superior advantages.

QUESTIONS AND EXERCISES

(Key to answers on page 570.)

(1) What is a partnership? What are the principal tests to be applied to determine whether a partnership exists?

(2) What are the main points which a partnership deed should cover? Is a written agreement essential?

(3) What is the firm name?

(4) What is meant by joint, and several, liability in connexion with partnership? What authority has each partner to bind the firm?

(5) What are the chief rights and duties of partners? How is the liability of incoming and outgoing partners determined?

(6) What are the main grounds for dissolution of partnership?

(7) State how the following matters will have to be dealt with in a partnership in the absence of specific agreement: (*a*) The allowance of interest on partners' capital. (*b*) The division of profits. (*c*) A change in the nature of the partnership business.

(8) Describe briefly the main provisions of the Registration of Business Names Act, 1916.

CHAPTER IX

PARTNERSHIP ACCOUNTS

(1) GENERAL

THE amount of capital to be subscribed by each partner upon formation of a partnership is a matter of agreement. The amounts will not necessarily be equal or in the same ratio as that in which profits are to be shared. The books of the partnership must therefore contain a clear record of the amount subscribed by each partner. This is achieved by opening individual Capital Accounts.

Example

Brown and Green agree to commence a new business in partnership. They open a banking account in the name of the firm on April 1 and pay in £6,000 and £4,000 respectively as capital. This will be recorded as follows:

CASH BOOK

19—		£			
April 1	To Brown, Capital A/c	6,000			
	Green, Capital A/c	4,000			

BROWN, CAPITAL ACCOUNT

			19—		£
			April 1	By Cash	6,000

GREEN, CAPITAL ACCOUNT

			19—		£
			April 1	By Cash	4,000

If a partnership is formed to take over an existing business that is owned by one of the prospective partners, the capital of that partner will be represented by the agreed value of the assets taken over from him. The other partner will normally pay in cash for his capital.

Example

White has been carrying on business for some time as a sole trader and his Balance Sheet on June 30 is as follows:

	£		£
White, Capital A/c	6,000	Freehold Premises	3,000
Sundry Creditors	1,500	Fixtures and Fittings	400
		Stock	2,500
		Sundry Debtors	1,100
		Cash at Bank	490
		Cash in Hand	10
	£7,500		£7,500

It is agreed that as from July 1 Black is to enter into partnership with White, introducing £4,000 for his capital. White's assets are to be taken over at the values shown in his Balance Sheet except that the freehold premises are to be revalued at £4,000. White's liabilities are to be taken over and discharged by the new firm. No adjustment is to be made for goodwill.

The opening entries in the partnership books would be as follows:

WHITE AND BLACK—JOURNAL

				£	£
19—					
July 1	Freehold Premises	Dr.		4,000	
	Fixtures and Fittings	,,		400	
	Stock	,,		2,500	
	Sundry Debtors	,,		1,100	
	Cash at Bank	,,		490	
	Cash in Hand	,,		10	
	To Sundry Creditors				1,500
	White, Capital A/c				7,000
	being assets and liabilities taken over from White, constituting his capital.			£8,500	£8,500
July 1	Cash (Bank)	Dr.		4,000	
	To Black, Capital A/c				4,000
	being capital introduced by Black.				

A new set of ledgers will be opened and the journal entries will be posted to the appropriate accounts therein. Alternatively, the existing Bought and Sales Ledgers may be continued, in which case it will not be necessary to post the items "Sundry Creditors £1,500" and "Sundry Debtors £1,100", as these figures represent the totals of the balances in the existing ledgers. A new General Ledger, Cash Book and Petty Cash Book will, however, be commenced, and the other items in the journal posted thereto.

Alternatively, if it is not desired to open any new account books, those used by White will be retained and it will merely be necessary to adjust (*a*) the values of those assets that are not to be transferred at their old book value, and (*b*) White's Capital Account balance, in such a way as is necessary to give effect to the agreement.

The adjusting journal entry will be as follows:

				£	£
19—					
July 1	Freehold Premises	Dr.		1,000	
	To White, Capital A/c				1,000
	being agreed increase in the value of freehold premises for the purpose of the partnership.				

The £4,000 paid in by Black will be entered in the Cash Book:

CASH BOOK

19—			£				
July 1	To Balance	b/f	490				
	Black, Capital A/c		4,000				

The Capital Accounts will be as follows:

WHITE, CAPITAL ACCOUNT

				19—			£
				July 1	By Balance	b/f	6,000
					Freehold Premises	J	1,000

BLACK, CAPITAL ACCOUNT

				19—			£
				July 1	By Cash	CB	4,000

VARIATIONS IN PARTNERS' CAPITAL

The amounts originally paid in or credited to the partners at the inception of the partnership will normally remain unaltered unless and until:

(1) They vary them by bringing in or drawing out cash, according to the needs of the business from time to time. This presupposes that the profits due to each partner will be credited to separate Current Accounts, to which will also be debited their drawings on account of profits.

(2) If separate Current Accounts are not maintained, the Capital Account balances will vary from year to year because the partners' shares of profits (and other adjustments, where applicable) will be credited thereto and their drawings on account of profits will be debited.

Although, as in (1) above, the capitals can be "fixed" in the sense that profits and drawings are dealt with in separate Current Accounts, it must be observed that the fixed capitals can subsequently be varied by agreement. In particular, if the business expands an increase in the capital employed in it may become essential, and if it cannot be obtained by some or all of the partners paying in cash, it may be brought about by restricting their drawings and transferring part of their Current Account balances to their Capital Accounts.

Alternatively, or in addition, money might be borrowed from some person who is not a partner, or a partner might agree to advance money to the firm as a loan, over and above his fixed capital. Section 24 of the Partnership Act provides that such a loan is to carry interest at 5 per cent per annum unless there is an agreement to the contrary.

Example

Mercer, Taylor and Cooper are in partnership as general merchants. On September 30 the balances on their Capital and Current Accounts were as follows:

	Capital Accounts	*Current Accounts*
	£	£
Mercer	5,000	2,000
Taylor	3,000	1,500
Cooper	2,000	(500 Dr.)
	£10,000	£3,000

There are some pressing liabilities to be met and additional capital is required to finance the business, which is expanding rapidly. It is agreed that:

(1) Amounts of £1,500 and £1,000 are to be transferred from the Current Accounts of Mercer and Taylor respectively to their Capital Accounts.

(2) Taylor is to introduce sufficient cash to make his capital equal to that of Mercer.

(3) Mercer is to lend the firm £2,000 at 6 per cent per annum, in addition to his capital.

(4) Cooper is to restrict his drawings so that the debit balance on his Current Account is worked off as soon as possible.

The effect of these adjustments, which were duly made on October 1, can be shown in the form of journal entries:

				£	£
19— Oct. 1	Current Accounts:	Dr.			
	Mercer			1,500	
	Taylor			1,000	
	To Capital Accounts:				
	Mercer				1,500
	Taylor				1,000
	being transfer of part Current A/c balances as agreed				
Oct. 1	Cash	Dr.		2,500	
	To Taylor, Capital Account				2,500
	being cash introduced by Taylor to bring the balance on his Capital A/c (£4,000) up to that on Mercer's Capital A/c (£6,500).				
Oct. 1	Cash	Dr.		2,000	
	To Mercer, Loan Account				2,000
	being loan at 6 per cent per annum interest, as agreed				

Note. The cash paid in by Mercer and Taylor has been journalized here in order to illustrate the double entry. In practice it would be posted from the Cash Book to the ledger accounts.

The provision that Cooper is to restrict his drawings until he has worked off the debit balance on his Current Account does not give rise to any entry in the books. The transfers from the Current Accounts of Mercer and Taylor to their Capital Accounts do not in themselves increase the immediate cash resources of the firm, but they reduce by £2,500 the amounts that these two partners are otherwise entitled to withdraw at any time in respect of past profits.

If the existing partnership agreement contains no provision for interest on capital, it would be equitable to introduce such a provision into the agreement now or else to give Mercer and Taylor an increased share in the profits to compensate them for the additional capital they have at stake. In the absence of such agreement Mercer and Taylor are not entitled to interest on capital and Mercer would have been entitled to 5 per cent per annum interest on his loan had the rate not been agreed at 6 per cent (S.24).

The ledger accounts (other than Cash Account) affected by the above adjustments will be as follows:

CAPITAL ACCOUNTS

		Mercer	*Taylor*	*Cooper*			*Mercer*	*Taylor*	*Cooper*
19—		£	£	£	19—		£	£	£
Oct. 1	To Balance c/d	6,500	6,500	2,000	Oct. 1	By Balance b/f	5,000	3,000	2,000
						Transfer from Current A/cs	1,500	1,000	
						Cash		2,500	
		£6,500	£6,500	£2,000			£6,500	£6,500	£2,000
					Oct. 1	By Balance b/d	6,500	6,500	2,000

CURRENT ACCOUNTS

		Mercer	*Taylor*	*Cooper*			*Mercer*	*Taylor*	*Cooper*
19—		£	£	£	19—		£	£	£
Oct. 1	To Balance b/f			500	Oct. 1	By Balance b/f	2,000	1,500	
	Transfer Capital A/cs	1,500	1,000			Balance c/d			500
	Balance c/d	500	500						
		£2,000	£1,500	£500			£2,000	£1,500	£500
Oct. 1	To Balance b/d			500	Oct. 1	By Balance b/d	500	500	

MERCER, LOAN ACCOUNT

(Interest 6 per cent per annum, payable ......)

		Interest	*Principal*			*Interest*	*Principal*
				19—			£
				Oct. 1	By Cash		2,000

As the entries in the Capital and Current Accounts are, in the main, similar in nature (though different in amount), they are written up here in columnar form, which is a time-saving device that can be adopted when working exercises and answering examination questions. In the books of the partnership separate accounts would, of course, be opened on different pages in the ledger.

Mercer's Loan Account is provided with double cash columns, so that when the interest is paid to him (probably half-yearly) it can be recorded in the same account as the principal of his loan. This will be a convenience in making the calculations of interest payable, particularly if the amount advanced by him is subject to alteration from time to time.

DIVISION OF PROFITS

The net profit of a partnership business has to be divided between the partners in accordance with the provisions of the partnership agreement, or, in default of agreement, according to the provisions of Section 24, Partnership Act, 1890. This division of profits is normally made once a year or at such intervals as may have been agreed.

The ascertainment of the profit itself depends upon the nature of the business carried on and the application thereto of the ordinary principles of double-entry book-keeping involved in the preparation of Trading and Profit and Loss Accounts. Nothing in the partnership agreement will normally have any bearing on the amount of the net trading profit; it is only the *division* of that profit between the partners that is laid down by the agreement. This division of the profit is shown in the separate section of the Profit and Loss Account known as the Appropriation Account, in which all adjustments between the partners, including their salaries (if any) and interest on capital (if applicable), should appear.

Example

Following the partnership changes recorded in the previous example, it is agreed that interest on capital shall be allowed at 5 per cent per annum and that Cooper, who devotes the whole of his time to the partnership business (whereas Mercer and Taylor are sleeping or dormant partners), shall receive a salary of £500 per annum. The balance of profit is then to be divided as follows: Mercer two-fifths, Taylor two-fifths, Cooper one-fifth.

The net trading profit for the year ended September 30, after providing for interest on the loan from Mercer but before giving effect to any of the other new provisions of the partnership agreement, was £4,000. The drawings of the partners during the year had been: Mercer, £900, Taylor £800, Cooper £600 (including his salary).

The Appropriation Account and the partners' Current Accounts will appear as follows:

Appropriation Account

for the year ended September 30

	£	£		£
To Interest on Capital:			By Net Profit brought down	4,000
Mercer, 5% on £6,500	325			
Taylor, 5% on £6,500	325			
Cooper, 5% on £2,000	100			
		750		
Partner's Salary—				
Cooper		500		
Balance, profit divisible:				
Mercer, 2/5ths	1,100			
Taylor, 2/5ths	1,100			
Cooper, 1/5th	550			
		2,750		
		£4,000		£4,000

Current Accounts

		Mercer	*Taylor*	*Cooper*			*Mercer*	*Taylor*	*Cooper*
19—		£	£	£	19—		£	£	£
Oct. 1	To Balance b/f			500	Oct. 1	By Balance b/f	500	500	
Sep. 30	Drawings	900	800	600	Sep. 30	Interest on Capital	325	325	100
	Balance c/d	1,025	1,125	50		Salary			500
						Share of Profit	1,100	1,100	550
		£1,925	£1,925	£1,150			£1,925	£1,925	£1,150
					Oct. 1	By Balance b/d	1,025	1,125	50

The debits in the Current Accounts for drawings are the total amounts drawn by each partner during the year under review. Each of these totals probably represents a number of smaller amounts drawn at regular or irregular intervals. These detailed amounts could either have been posted from the Cash Book directly to the Current Accounts or separate Drawings Accounts could have been opened to receive the detailed postings, the totals then being transferred to the Current Accounts at the end of the year. Where interest is to be charged on drawings (not applicable in this example), it is generally more convenient to open separate Drawings Accounts. The calculation of interest on drawings is considered in Chapter XVI.

Interest on the loan of £2,000 from Mercer does not appear in the Appropriation Account (it has already been charged in the Profit and Loss Account before striking the balance of net profit, £4,000). It does not appear in Mercer's Current Account either, the Loan Account having been provided with Interest columns to record the amounts due. The entries in the Loan Account, assuming the interest for the first half-year to have been paid on April 1, and for the second half-year to be due but unpaid on September 30, will be as follows:

MERCER, LOAN ACCOUNT

19—		Interest	Principal	19—		Interest	Principal
April 1	To Cash	60		Oct. 1	By Cash		2,000
Sept.30	Balance c/d	60	2,000	Sept.30	Profit and Loss A/c	120	
		£120	£2,000			£120	£2,000
				Oct. 1	By Balance b/d	60	2,000

DIVISION OF PROFITS IN THE ABSENCE OF AGREEMENT

If the partnership agreement contains no provision regarding the way in which profits are to be shared, Section 24 of the Partnership Act, 1890, will apply. This may lead to a most inequitable result, in circumstances such as the following:

A, B and C are trading in partnership without any agreement as to the division of the profits. Capital has been contributed as follows—A £10,000, B £1,000 and C £1,000. A is a sleeping partner, B devotes about one day a week to the partnership business, while C acts as manager and devotes the whole of his time thereto. In accordance with Section 24:

(1) The profits are divisible equally, notwithstanding that capitals have not been contributed equally.

(2) A, who has invested, proportionately, much more capital than B or C, is not entitled to any interest thereon.

(3) C is not entitled to any salary for his full-time services.

When the time comes to prepare the first annual accounts, however, the partners may in fact agree upon some more equitable division of the profits and it will then be unnecessary to apply Section 24.

If, by agreement, profits are shared in the same ratio as that in which capital has been provided, then a provision for allowing interest on capital makes no difference to the effective division of profit. Thus, if X and Y share profits in the ratio of two-thirds and one-third respectively, and their capitals are £4,000 and £2,000, the division of a profit of £900 for a year would be as follows:

(*a*) If there is no provision for interest on capital—

X Two-thirds of £900 = £600
Y One-third of £900 = £300

(*b*) If interest on capital is to be allowed at 5 per cent per annum—

X	Interest on £4,000 =	£200	
	Share of profit (£600)	£400	
		——	Total £600
Y	Interest on £2,000 =	£100	
	Share of profit =	£200	
		——	Total £300

SPECIAL PROFIT-SHARING ARRANGEMENTS

It is not necessary that the balance of profit should be shared in any simple ratio. Differential scales of profit-sharing may be employed, or one or more of the partners may be guaranteed by the others that their shares will not be less than a certain amount.

Example (*a*)

Under the partnership agreement between P, Q and R profits are to be shared as follows:

	P	Q	R
The first £1,000 per annum	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
The next £1,200 per annum	$\frac{1}{3}$	$\frac{1}{3}$	$\frac{1}{3}$
Any surplus over £2,200 per annum	$\frac{1}{4}$	$\frac{1}{4}$	$\frac{1}{2}$

If the profit for the year ended March 31 is £3,000 the Appropriation Account will appear as follows, there being no provision for interest on capital or partners' salaries:

	£	£		£
To P:			By Net Profit, brought down	3,000
2/5ths of £1,000	400			
1/3rd of £1,200	400			
1/4th of £800	200			
		1,000		
Q (as for P)		1,000		
R:				
1/5th of £1,000	200			
1/3rd of £1,200	400			
1/2 of £800	400			
		1,000		
		£3,000		£3,000

Example (*b*)

L, M and N share profits in the ratio of 4 : 3 : 2, but it is agreed that if N's share on this basis is less than £1,000 it is to be made up to that figure by reducing the shares of L and M proportionately. If the profit for the year ended April 30 is £3,600, the Appropriation Account will appear as follows:

To L. 4/9ths of £3,600	1,600	0	0				By Net Profit, brought down	3,600	0	0
Less Transfer to N 4/7ths of £200	114	5	9							
				1,485	14	3				
M. 3/9ths of £3,600	1,200	0	0							
Less Transfer to N 3/7ths of £200	85	14	3							
				1,114	5	9				
N. 2/9ths of £3,600	800	0	0							
Add Transfer from L and M re guaranteed minimum share	200	0	0							
				1,000	0	0				
				£3,600	0	0		£3,600	0	0

Where an exceptional arrangement such as either of the above is contemplated, the partnership agreement should state clearly how losses,

if incurred, are to be borne. In the absence of agreement to the contrary, losses are normally shared in the same ratio as profits, but this rule could not be applied in the circumstances of Example (*a*). It might, therefore, be necessary to apply Section 24 and divide losses equally, if the agreement is silent on this point. In Example (*b*), however, N would still be entitled to be credited with £1,000 for his share of "profit" even if this resulted in M and N being debited with an additional loss of that amount.

VARIATION OF THE PROFIT-SHARING AGREEMENT

A well-drawn partnership agreement normally contains a provision that once the accounts for a year have been drawn up and accepted by the partners they cannot afterwards be disputed (save, possibly, to correct a manifest error). If, however, *all* the partners so agree, accounts for past years can be amended, notwithstanding such a provision in the agreement.

The normal reason for this would be to give effect to a change in the profit-sharing arrangements that is intended to have retroactive effect. The figures that have already been entered in the books cannot be amended but the Appropriation Accounts for the years involved can be redrafted on paper and the amount due to each partner under the revised appropriation compared with the amount already credited to him under the old agreement that is being superseded. As the total amount of the profit available is not being altered, the additional amounts due to some partners must be exactly counterbalanced, in total, by amounts to be surrendered by others. A journal entry then suffices to make the necessary transfers in the partners' Current Accounts.

Example

The profits of a firm for the past three years, totalling £12,000, have been shared equally by the partners A, B and C. It is agreed that as A has in fact devoted very little time to the partnership affairs during that period, his share is to be reduced to a quarter, B and C sharing the remaining three-quarters equally, and the agreement is to be backdated to the beginning of the period of three years.

The amending journal entry will be:

			£	£
A, Current A/c			1,000	
To B, Current A/c				500
C, Current A/c				500
being revision of partnership agreement with effect from January 1, 19—.				
		£		
Profit for 3 years		12,000		
A's share under old agreement	1/3	4,000		
A's share under new agreement	1/4	3,000		
Additional profit to be shared equally by B and C		£1,000		

CAPITAL PROFITS AND LOSSES

The partners' agreement as to the way in which profits or losses are to be shared normally extends to all profits or losses and not merely to the annual results of trading. This applies particularly to the ultimate profit or loss on sale of the assets of a partnership, when it has been brought to an end; this and other matters arising from the dissolution of a partnership are considered in Chapter X.

A *capital* profit or loss may arise during the course of a partnership in circumstances such as the following:

Example

Smith and Jones are in partnership sharing profits equally; their capitals are £10,000 and £5,000 respectively. The freehold premises which they own as partnership property are shown in their last Balance Sheet at £9,000 (the original cost less depreciation written off). The premises occupy a commanding corner site and have recently been valued for the purpose of insurance at £15,000. The partners wish to revalue the premises in their books so that they appear at the revised value.

Smith argues that the resulting appreciation of £6,000 is a capital profit, attributable to the capital that was originally sunk in the purchase of the premises, and that as his capital is twice that of Jones, the profit should be shared accordingly, Smith £4,000, Jones £2,000.

Jones argues that this is a partnership profit and that in accordance with their agreement as to sharing profits it should be divided equally. He also points out that this profit is, to a certain extent, the writing back of depreciation that has been written off in the past, which depreciation was charged in the annual Profit and Loss Account and therefore shared equally.

Jones's argument is correct and must prevail, unless there is some special clause in their partnership agreement which would require the matter to be dealt with differently. As the "writing up" of the property is a mere book entry and does not increase the cash resources of the business the resulting credits should be made in the Capital Accounts of the partners—not in their Current Accounts.

GOODWILL

It has already been seen that the purchaser of a business concern may pay a lump sum which is in excess of the total value of the tangible assets of the business. The resulting difference in the opening journal entry was carried to the debit of Goodwill Account. It represents the cost of goodwill purchased by the trader, goodwill being an asset that is recognized in the commercial and professional world as being capable of being bought and sold, although it has no physical existence like plant and stock-in-trade, and no tangible existence like book debts and other assets which represent legal claims to money.

If goodwill is capable of being bought and sold it must have some specific attributes and be capable of valuation. Its most important specific

attribute is that the purchaser acquires the right to carry on an existing business and to hold himself out as the legal successor to the previous owner. The sale of goodwill normally includes the right to continue the business in the name in which it was previously carried on and to take all other reasonable steps to secure that people who traded with the previous owner will continue to trade with his successor.

Goodwill has been defined as "the benefit attaching to reputation or connexion." Reputation may, of course, be a personal attribute of the individual who carried on the business, and in such cases it is not always easily and successfully transferable to a successor. It may equally well be an attribute of the business itself, arising from the excellence of its products or the efficiency of its organization. Such attributes are more easily and successfully transferable to another person, and in such cases goodwill will usually command a higher price.

Goodwill may also arise from locality. This is particularly true of licensed premises and of shops in important shopping thoroughfares. In such cases the value of the goodwill is frequently merged in the value of the premises themselves. Thus, in the last example, if the partners had sold their business, a purchaser who paid £15,000 for the premises, at their revised value, would not also pay a large sum for goodwill. Had the premises been sold to him at their book value of £9,000, however, the additional payment for goodwill would presumably have been not less than £6,000.

A purchaser who buys goodwill does so in the expectation that he will succeed to a profitable business; the valuation of goodwill is therefore essentially linked up with the amount of profits that may reasonably be expected to be made in the future. In other words, it is the expectation of future profits rather than the fact that profits have been made in the past that leads a purchaser to buy goodwill. The profits made in the past, however, will normally be the only available guide to future profits, and the upward or downward trend of profits will be of particular importance.

The accurate valuation of goodwill is a very difficult matter, depending to a large extent on the nature and custom of the trade or profession concerned, and it is one upon which professional advice would normally be taken when buying a business for a substantial sum.

The saleable value of goodwill also depends to a large extent on current financial conditions. In times of great financial and commercial activity, known as boom conditions, very large sums may be paid for goodwill by persons who are willing to purchase businesses at almost any price that may be asked. On the other hand, under slump conditions, although a business may still have a valuable goodwill, it may be almost impossible to sell it. The law of supply and demand is therefore seen to operate in this as in other matters, and it is impossible to lay down any arithmetical method of calculation that would operate correctly in all the circumstances possible.

The simplest and commonest method, where a valuation is necessary, is to take so many years' purchase of the net trading profits of the business. In some cases, particularly where professional practices are involved, it is more common to base the calculation on the annual takings of the

practice. Where the calculation is based on net profits, these may be the actual net profits as shown by the Profit and Loss Accounts or the reduced "super profit," which is the balance remaining after providing for reasonable remuneration for the proprietor's services and for interest on capital that will have to be sunk in the purchases of the other assets.

Example

A sole trader has been carrying on business for some years, his profit for the last five years, before making any provision for the value of his own services or for interest on his capital, being as follows: £1,200, £1,500, £1,400, £1,600, £1,800.

A reasonable charge for management salary was estimated as £500 a year and the value of the net assets employed in the business (excluding goodwill) at the date of sale was £8,000.

(1) Valuation of goodwill at (say) 2 years' purchase of average profits for the past 3 years

		£
Profits	1st year	1,400
,,	2nd ,,	1,600
,,	3rd ,,	1,800
		£4,800
Average profits		£1,600
Goodwill, valued at 2 years' purchase thereof		£3,200

(2) Valuation of goodwill at (say) 4 years' purchase of average super profits for the past 4 years:

			£
Profits	1st year		1,500
,,	2nd ,,		1,400
,,	3rd ,,		1,600
,,	4th ,,		1,800
			£6,300
Average profits			£1,575
		£	
Deduct Management Remuneration		500	
Interest on capital at, say, 6 per cent per annum		480	
			980
Average super profits			£595
Goodwill, valued at 4 years' purchase thereof			£2,380

Goodwill is of greatest importance in partnership accounts because it is one of the assets of the firm in which all the partners are entitled to share unless they have agreed to the contrary. In view of the difficulty of accurate valuation, partnership agreements frequently lay down the basis upon which it is to be calculated for the purpose of a change in the partnership (for example, the admission of a new partner).

Where, however, goodwill is actually bought (for example, where an existing business is acquired by the firm) or sold, its value will be determined on that date by the amount actually paid or received for it and not by the terms of the agreement. When the value is required on any other date it will, of course, be necessary to apply the agreement, for goodwill is essentially an asset which is liable to vary in value from one year to another.

Changes in value of goodwill are, however, ignored until some circumstance, such as the admission of a new partner, arises and makes a revaluation essential. When such an occasion arises the simplest procedure is to:

(1) Value goodwill according to the terms of the partnership agreement or, if there is no basis laid down, as may be agreed.

(2) Adjust the book value of goodwill to the new value by crediting or debiting an appropriate amount to the Capital Accounts of the partners in the ratio in which they shared profits and losses before the change.

Example (a)

Mortise and Tenon have been in partnership for some years, sharing profits in the ratio of 3 to 2. Goodwill stands in their books at cost, £2,000. Mitre is to be admitted as a partner on April 1, the goodwill of the firm on that date being agreed to be worth £5,000. The other assets are not to be revalued. Mitre is to be entitled to a quarter share of the profits, Mortise and Tenon sharing the remaining three-quarters in the same ratio as before.

Note. The new profit-sharing arrangement will, therefore, be:

Mortise	3/5ths of 3/4ths	= 9/20ths
Tenon	2/5ths of 3/4ths	= 6/20ths
Mitre	1/4th	= 5/20ths

which can be expressed as a ratio of 9 : 6 : 5.

The balances standing to credit of the existing Capital Accounts are Mortise £5,000, Tenon £4,000. Mitre is to introduce £3,000.

The journal entry necessary to give effect to the revaluation of goodwill is as follows:

			£	£
19— April 1	Goodwill	Dr.	3,000	
	To Mortise, Capital A/c			1,800
	Tenon, Capital A/c			1,200
	being excess of valuation of goodwill £5,000 over existing value in the books of the firm.			

The Capital Accounts will appear thus:

			Mortise	Tenon	Mitre				Mortise	Tenon	Mitre
19—			£	£	£	19—			£	£	£
Apr. 1	To Balance	c/d	6,800	5,200	3,000	Apr. 1	By Balance	b/f	5,000	4,000	
							Goodwill	J	1,800	1,200	
							Cash	CB			3,000
			£6,800	£5,200	£3,000				£6,800	£5,200	£3,000
						Apr. 1	By Balance	b/d	6,800	5,200	3,000

Example (*b*)

If in the above example it had been agreed that as from April 1 the profit-sharing ratio as between Mortise and Tenon was also to be altered, future profits being shared in the proportions, Mortise a half, Tenon a quarter and Mitre a quarter, the entries in the books would be precisely the same. This is because the credits to the existing partners arising from the revaluation of goodwill are made in the old profit-sharing ratio. The building up of goodwill from its original value of £2,000 to its present value £5,000 is a capital profit which was earned during the past years.

Further, so far as these entries are concerned, it is really immaterial whether Mitre is to receive a quarter share or some other proportion of the future profits. He does not have to buy a share of goodwill from Mortise and Tenon; they have in effect received payment by the credit entries in their Capital Accounts. So far as goodwill is concerned, Mitre's share of profit is only of significance in that he will be entitled to that extent to share in any *future* appreciation in its value over and above £5,000.

GOODWILL NOT RECORDED IN PARTNERSHIP BOOKS

Although the goodwill of a partnership is an asset which belongs to a firm as a whole, its value is dependent on the profits of the partnership business and therefore, proportionately, can be said to attach to the share of profit enjoyed by each partner. Thus, to say that the value of a firm's goodwill is £5,000 is equivalent to saying that the goodwill of a quarter share in the firm's profits is worth a quarter of £5,000 = £1,250.

This argument assumes importance when it is not desired to bring goodwill into the books as an asset. It is often felt that in view of its intangible nature and the fluctuations in value to which it is susceptible, it is better not to bring it into the books if that can be avoided.

In such a case, where an incoming partner is required to make a payment for goodwill, he is regarded as buying his share of that asset from the former partners, who are having their own share of profit reduced accordingly. Provided that, as between themselves, the existing partners are going to share profits in the same way as before the introduction of the new partner, the latter can be said to be buying his share proportionately from all the former partners. The amount he pays, generally known as a premium, is then shared by them in that ratio.

Example

Bishop, Canon and Priest, who share profits in the ratio 3 : 2 : 2, admit Deacon as a partner as from July 1. The goodwill of the firm is valued at £11,200 and Deacon is to pay the existing partners a premium of £1,400 as a consideration for acquiring a one-eighth interest in the firm. The new profit-sharing ratio will be 3 : 2 : 2 : 1.

The premium of £1,400 should be divided between Bishop, Canon and Priest as follows:

Bishop, three-sevenths of £1,400 = £600.
Canon, two-sevenths of £1,400 = £400.
Priest, two-sevenths of £1,400 = £400.

These amounts will either be paid to them personally by Deacon (in which case no record of the transaction will appear in the partnership books), or, if it is desired that the £1,400 should be employed in the business as additional capital, it will be paid into the firm's bank account and credited to the three former partners in the above proportion.

On the other hand, if the former partners are not to continue to share profits in the same ratio as before, the above method would not, in itself, give the correct result. In addition to the sharing of the premium paid by the incoming partner, those partners who are having their share of profit increased will have to make appropriate payments for goodwill to the others who are having their shares reduced. Similar adjustments are necessary when there is a change in the profit-sharing agreement of an existing firm and goodwill is not recorded in the books.

Example

A, B, C and D have been sharing profits in the ratio 3 : 3 : 2 : 2. The goodwill of the firm does not appear in the books, but it is agreed to be worth £6,000. As from April 1 the profit shares are to be revised as follows: A, three-twelfths; B, two-twelfths; C, four-twelfths; D, three-twelfths.

The following goodwill adjustments should be made:

A's share is being reduced from three-tenths to three-twelfths, a reduction of $\frac{3}{10} - \frac{3}{12} = \frac{18 - 15}{60} = \frac{3}{60} = \frac{1}{20}$, the goodwill value of which is $\frac{£6{,}000}{20} = £300$.

B's share is being reduced from three-tenths to two-twelfths, a reduction of $\frac{3}{10} - \frac{2}{12} = \frac{18 - 10}{60} = \frac{8}{60} = \frac{2}{15}$, the goodwill value of which is $\frac{£6{,}000 \times 2}{15} = £800$.

C's share is being increased from two-tenths to four-twelfths, an increase of $\frac{4}{12} - \frac{2}{10} = \frac{20 - 12}{60} = \frac{8}{60} = \frac{2}{15}$, the goodwill value of which is £800 as above.

D's share is being increased from two-tenths to three-twelfths, an increase of $\frac{3}{12} - \frac{2}{10} = \frac{15 - 12}{60} = \frac{3}{60} = \frac{1}{20}$, the goodwill value of which is £300.

Therefore, either C should pay B £800 and D should pay A £300, or the matter can be adjusted in their Capital Accounts by the following journal entry:

19—			£	£
April 1	C, Capital A/c	Dr.	800	
	D, Capital A/c	,,	300	
	To A, Capital A/c			300
	B, Capital A/c			800
	being goodwill adjustment consequent upon change in the profit-sharing agreement.			

The same result would be achieved if goodwill were written into the books, crediting each partner with his share of the £6,000 in the old ratio (A £1,800, B £1,800, C £1,200 and D £1,200), and then written off again by debiting each partner with his share of the £6,000 in the new ratio (A £1,500, B £1,000, C £2,000 and D £1,500).

QUESTIONS AND EXERCISES

(Key to answers on page 570.)

(1) Draw up a Balance Sheet in proper form from the following Trial Balance extracted from the books of Evans and Taylor. They share profits and losses: Evans, three-fifths; Taylor, two-fifths.

Trial Balance, December 31

	Dr. £	Cr. £
Net Profit for the year		3,000
Evans:		
Capital Account Balance, Jan. 1		3,000
Current Account Balance, Jan. 1		800
Taylor:		
Capital Account Balance, Jan. 1		2,000
Current Account Balance, Jan. 1		700
Drawings during year:		
Evans	2,400	
Taylor	1,600	
Loan, F. White		750
Stock on hand, Dec. 31	1,990	
Freehold Property	3,500	
Sundry Debtors	965	
Sundry Creditors		800
Plant and Machinery	1,150	
Bank Overdraft		610
Cash in Hand	55	
	£11,660	£11,660

(*R.S.A. Stage I*).

(2) J. Baxter and D. Dexter carry on business as partners in Boot and Shoe Retailers and Repairers. The following balances were shown by the books at December 31:

	£	£
J. Baxter: Capital Account		1,009
Drawings Account	816	
D. Dexter: Capital Account		658
Drawings Account	816	
Sales (Retail £4,794; Repairs £3,307)		8,101
Purchases (Retail £3,215; Repairs £1,612)	4,827	
Shop Fixtures and Fittings (Retail) at January 1	300	
Rent (Retail £208; Repairs £104)	312	
Wages: sales staff	569	
repairers	695	
Creditors		28
Tools	81	
Repairs to Premises	98	
Rates and Water (Retail £41; Repairs £21)	62	
Bank Balance	672	
Advertising (Retail £123; Repairs £41)	164	
General Expenses (Retail £75; Repairs £102)	177	
Machinery at January 1	260	
Cash in Hand	72	
Loan Account, J. Baxter, at January 1		600
Stock on hand at end of previous year (Retail £341, Repairs £58)	399	
Lighting and Heating (Retail £38; Repairs £38)	76	
	£10,396	£10,396

You are required to prepare the Trading and Profit and Loss Account for the year ending December 31, showing the profit of each department and Balance Sheet at that date after making adjustments for the following:

(*a*) The Stock on hand at December 31 was valued at Retail £124 and Repairs £29.

(*b*) Depreciate Shop Fixtures and Fittings at 10 per cent per annum.

(*c*) Depreciate Machinery which was used in Repairs departments at 20 per cent per annum.

(*d*) Reserve for interest on the loan at 5 per cent for the year.

(*e*) The expenditure on Repairs to Premises is recoverable in full from the War Damage Commission.

(*f*) J. Baxter and D. Dexter share profits and losses in the proportions of two-thirds and one-third respectively.

(*R.S.A. Stage II*).

(3) Foxley and Green agree to admit Holiday as a partner as from January 1 upon the following terms:

(*a*) Holiday to bring in £5,000, of which £1,500 is to be regarded as a premium and credited equally to Foxley and Green.

(*b*) Before Holiday is admitted as a partner it is agreed that a Reserve of 5 per cent shall be created on debtors for doubtful debts.

(*c*) Profits to be divided as follows: Foxley and Green two-fifths each, Holiday one-fifth.

The Balance Sheet of Foxley and Green at December 31 was as under:

Creditors	5,790 10 0	Plant	£15,300		
Capital—		Less Dep.	3,300		
Foxley	8,500 0 0			12,000 0 0	
Green	8,500 0 0	Debtors		3,660 0 0	
		Stock		5,720 6 8	
		Bank Balance		1,410 3 4	
	£22,790 10 0			£22,790 10 0	

Show the Balance Sheet of the new firm on January 1.

(*L.C. of C. Certificate*).

(4) Brown, Green and White were in business as exporters. The capital of the firm was fixed at £20,000 and was held as to £12,000 by Brown and as to £8,000 by Green. Brown and Green were equal partners. White, Brown's son-in-law, had no capital in the business and had been admitted to partnership on the terms that he was to be paid a salary of £400 (one-half of which was to be charged to Brown) and to have one-ninth of the profits, the whole of which was to be borne by Brown. In the event of a loss being made, White was to be charged with his share of the loss and Brown to be correspondingly relieved. Partners are entitled to be credited with 5 per cent interest on their capitals in the business, but not on current accounts, nor is interest to be charged on drawings.

On December 31, 1948, the following amounts were standing to the credit of partners' current accounts: Brown £730, Green £620 and White £120, and during the year 1949 the partners had drawn—Brown £1,000, Green £750 and White the amount of the agreed salary and also £100.

The profit of the firm for the year 1949, before charging either interest on capital or White's salary, was £930.

You are required to prepare the Profit and Loss Appropriation Account for the year to December 31, 1949, and the partners' Current Accounts for the year.

(*R.S.A. Stage II*).

(5) Brown, Jones and Casey are trading in partnership on the following terms:

(*a*) Casey receives a salary, payable monthly, at the rate of £300 per annum.

(*b*) Interest is credited at the rate of 5 per cent per annum on capital, but not on Current Accounts. So long as the balance on any partner's drawings account is less than the credit balance on his Current Account, no interest is charged on his drawings, but when the drawings exceed the Current Account, so that the two together show a debit balance, interest at the rate of 5 per cent per annum is charged on the excess.

(*c*) Of the remaining profit Brown takes five-tenths, Jones four-tenths and Casey one-tenth.

The firm's Profit and Loss Account for the year to December 31 showed divisible profit amounting to £3,102 12s. 6d. before charging partnership interest or salary. The partners' Capital and Current Accounts as at the beginning of the year were:

	Capital Accounts	*Current Accounts*
	£	£
Brown	12,000	560 Cr.
Jones	8,000	450 Cr.
Casey	2,000	560 Cr.

No capital was introduced or withdrawn during the year. The partners had made regular drawings on account of profits, on the last day of every month, as follows: Brown £120, Jones £100 and Casey (excluding salary) £20; in addition Brown had drawn £200 in February.

Show the Appropriation Account and the partners' Current Accounts for the year.

(6) X and Y were trading in partnership, sharing profits in the proportion of 3 to 2. On September 30 their Capital Accounts were £10,000 and £5,000 respectively, and goodwill stood in the books at £2,000.

On October 1 Z joined the firm as a partner on the terms that he was to bring in £3,000 in cash, that profits were to be shared between X, Y, and Z in the proportions of 9, 6 and 5, that adjustments between partners should be made on the basis of the firm's actual goodwill being worth £4,500, and that the figure of goodwill in the firm's books should remain standing at £2,000.

Set out the partners' Capital Accounts. (*L.C. of C. Higher*).

(7) Up to September 30 Johnson was carrying on his business as a sole trader. His Balance Sheet drawn up as on that date showed his capital at £5,600 and disclosed no entry for goodwill.

On October 1, Brown joined Johnson as a partner in the business, bringing in £2,000 in cash. Johnson withdrew £1,000 on the same day. Brown was to have a two-fifths interest in the profits and goodwill but no figure of goodwill was to stand in the firm's books. The goodwill of the business was agreed to be worth £1,500.

Show journal and ledger entries recording the above matters in the books of the business. (*Chartered Accountants, Inter.*).

(8) J, K and L carry on business in partnership, and their profits for the year ended December 31 were £3,385 before taking into account interest on capital at $4\frac{1}{2}$ per cent per annum, partners' salary and interest on drawings.

(*a*) The partners' Capital Accounts at December 31 were as follows:

J	£5,000
K	10,000
L	12,000

(*b*) K was entitled to a salary of £600 per annum.

(*c*) Interest chargeable to the partners on Drawings Accounts was:

J	£6
K	12
L	22

(*d*) The balance of profits was shared between J, K and L in the proportions 6 : 3 : 1.

(*e*) K's share of profit, exclusive of salary and interest on capital and drawings, was guaranteed personally by J to be at least £600 per annum.

You are required to show the Profit and Loss Appropriation Account for the year ended December 31. (*Chartered Accountants, Inter.*).

(9) Green, White and Gray commenced trading in partnership on February 1. No agreement was entered into at the time as to how profits should be shared, this being left for settlement later. Capital was brought in as follows:

	£	£
Green, February 1		10,000
White, February 1	5,000	
June 1	2,000	
		7,000
Gray, February 1		3,000

Green also brought in £2,000 by way of loan on March 1, £800 of which was repaid on September 1. The balance was still outstanding on October 31 following. Gray devoted substantially his whole time to managing the firm's business, while Green and White gave very little time.

A Profit and Loss Account prepared for the period from the commencement to October 31 showed a net profit of £2,712 before charging any interest. The partners were unable to agree to any terms except that Gray's share for the nine months was not to be less than £900.

Show the appropriation of the profit for the period, ignoring taxation. (*Chartered Accountants, Inter.*)

(10) Andrews and Brown are partners in a manufacturing business. Interest at 5 per cent per annum is allowed on capital, but not on Current or Drawings

Accounts, and the balance of profit or loss is divisible in the proportion of 3 to 2.

The following Trial Balance was extracted from the firm's books as on March 31, 1949:

	Dr. £	Cr. £
Andrews: Capital Account, March 31, 1948		37,000
Current Account ,,		318
Brown: Capital Account ,,		13,000
Current Account ,,	236	
Drawings during year: Andrews	5,000	
Brown	1,800	
Plant and Machinery, March 31, 1948	26,000	
Furniture and Fittings, March 31, 1948	5,400	
,, ,, ,, bought Sept. 30, 1948	400	
Stock on hand, March 31, 1948:		
Raw Materials	7,350	
Finished Goods	9,420	
Work-in-Progress, March 31, 1948	2,770	
Purchases, net	37,710	
Sales, net		68,280
Salaries and Wages: Factory	8,850	
Office	2,340	
Rent and Rates	2,740	
Heat and Light	226	
Insurance	1,508	
Bought Ledger Balances		8,480
Sales Ledger Balances	16,380	30
Packing Department, Wages and Materials	792	
Factory Power	1,730	
Repairs to Plant	509	
Advertising	1,270	
Provision for Bad Debts		76
Sundry Factory Expenses	617	
Discount		351
Trade and Office Expenses	690	
Bank Overdraft		6,551
Bank Interest and Charges	231	
Cash in Hand	117	
	£134,086	£134,086

You are required to prepare the firm's Manufacturing, Trading and Profit and Loss Account for the year ended March 31, 1949, and Balance Sheet as on that date, taking into account the following information and instructions:

(*a*) The following valuations were made on March 31, 1949:
Stock of Raw Materials, £10,200
Stock of Finished Goods, £6,280.
Stock of Packing Materials, £74.
Work in Progress, £3,310.

(*b*) Provision is to be made for outstanding expenses as follows: Rent £500, Heat and Light £86, Sundry Factory Expenses £73, and Office and Trade Expenses £54.

(*c*) Insurance paid in advance was calculated at £360.

(*d*) Seven-eighths of the rent, rates, heat and light, and three-quarters of the insurance are to be taken as attributable to the factory and the remainder to the office, etc.

(*e*) Depreciation is to be provided at the following rates per annum: Plant and Machinery 10 per cent; Furniture and Fittings 5 per cent.

(*f*) The Provision for Bad Debts is to be made up to £350.

(*Chartered Accountants, Inter.*)

CHAPTER X

PARTNERSHIP ACCOUNTS

(2) DISSOLUTIONS

WHEN a partnership comes to an end, for any of the reasons set out in Chapter VIII, it is said to be dissolved. As a partnership is really the relationship between the partners for the time being it follows that, in the widest sense, a partnership is also dissolved when there is any change in its constitution. Thus, the admission of a new partner to an existing firm really involves the dissolution of the old partnership and the commencement of a new one.

Since, in such cases, no partner has left the firm, such changes are not normally regarded as dissolutions; they have already been considered in Chapter IX. It is now necessary to consider:

(1) Partial dissolutions, where one or more of the partners leave the firm but the partnership business is continued by one or more of the other partners.

(2) Complete dissolutions, where the assets of the partnership are sold, its liabilities are discharged and the balance remaining is divided between the partners.

Partial dissolution can be brought about only by agreement between all the former partners or their representatives, either in circumstances such as are envisaged by Section 33 of the Partnership Act, 1890, which provides that death or bankruptcy of a partner dissolves the firm unless there is an agreement to the contrary, or where one or some of the partners wish to retire and it is agreed that the other partners shall continue to carry on the business. The book-keeping problems arising in such a case are confined to the calculation of the amount due to the outgoing partner or partners and the way in which such sum is to be paid to them.

A complete dissolution, on the other hand, is necessary in every case where the existing partnership is discontinued and there is no arrangement for the business to be continued by one or some of the existing partners. The business may be sold as a going concern to a purchaser who was not previously interested in it, or the various assets may be sold piecemeal.

In either case it is primarily necessary to consider how the liabilities and obligations of the old partnership to its creditors are to be discharged before the rights of the partners to share in the proceeds of realization can be dealt with.

AMOUNT DUE TO AN OUTGOING PARTNER

If the books of the partnership have been properly kept the amounts due to any partner for capital and undrawn profits will be shown as balances on his Capital Account and Current Account respectively. The amount standing to credit of his Current Account will represent

undrawn profits up to the date of the last Balance Sheet, less his drawings since that date. (If the drawings have been recorded in a separate Drawings Account, the total to date will be transferred to the debit of the Current Account; this may in some cases have the effect of producing a debit balance on Current Account which will then have to be deducted from the total amount otherwise due to the outgoing partner.)

In the case of a partner retiring by agreement, the change will probably occur on the normal Balance Sheet date of the firm or at some other convenient date which will enable a proper Trading and Profit and Loss Account to be drawn up to that date. The partner's Current Account will then show the amount due to him for undrawn profits right up to date.

On the other hand, the death or bankruptcy of a partner may occur at any date during the year and the date cannot be determined until the event happens. It is then probably too late to take stock and prepare accurate accounts for the exact period from the date of the last Balance Sheet up to the happening of the event which has brought about the change in the partnership.

The outgoing partner is nevertheless entitled to be credited with his normal share of profits up to date, unless the partnership agreement has specifically made some other provision. The procedure to be adopted, unless already laid down in the partnership agreement (which is always desirable) must be agreed between the interested parties. The methods most commonly adopted are:

(1) To prepare accounts to the next convenient date (normally the usual accounting date, one year later than that of the last Balance Sheet) and to apportion the profits thus disclosed, giving the outgoing partner a fair proportion of what he would have been entitled to had he remained in the firm for the whole period.

Example

The firm of A, B and C made up its accounts regularly to December 31 each year. B died on September 30 and it was not practicable to prepare accounts for the nine months ended on that date. The partnership agreement provided for interest on capital at 5 per cent per annum, and B and C were entitled to salaries of £600 and £400 per annum respectively, the balance of profit then being divisible in the ratio 3 : 2 : 1. The appropriate balances in the books on January 1 were:

	Capital Accounts	*Current Accounts*
	£	£
A	10,000	1,500 Cr.
B	4,000	1,000 Cr.
C	2,000	600 Cr.

The net profit of the year ended December 31 following the date of B's death was £4,040, and as the business was of a non-seasonal nature it was agreed that this could be regarded as accruing evenly over the year. In the nine months ending on the date of his death B had drawn £800, including his salary.

APPROPRIATION ACCOUNT

for the year ended December 31

	9 months ended Sept. 30	*3 months ended Dec.* 31		*9 months ended Sept.* 30	*3 months ended Dec.* 31
	£	£		£	£
To Interest on on Capital			By Net Profit, brought down:		
A	375	125	9 months to Sept. 30, 3/4ths of £4,040	3,030	
B	150	—			
C	75	25			
Salaries:					
B	450	—			
C	300	100	3 months to Dec. 31, 1/4th of £4,040		1,010
Balance divisible:					
A	840	570			
B	560	—			
C	280	190			
	£3,030	£1,010		£3,030	£1,010

Note. The profit-sharing ratio as between A and C was 3 : 1. The balance of profit for the first nine months is, therefore, divided as to A one-half, B one-third and C one-sixth, while for the last three months the basis of division is A three-quarters and C one-quarter.

B, CURRENT ACCOUNT

19—			£	19—			£
Sept. 30	To Drawings		800	Jan. 1	By Balance	b/f	1,000
	Balance transferred to Exors. of B A/c		1,360	Sept. 30	Interest on capital		150
					Salary		450
					Share of Profit		560
			£2,160				£2,160

Note. B's Current Account merely shows the net balance due to him for undrawn profits; this balance is transferred to an account in which will be shown eventually the total amount due to his executors (or other persons legally responsible for the administration of his estate). B's right to be credited with salary clearly determines at the date of his death; interest on his capital may continue to accrue up to the date on which a final settlement is made, but that is a matter to be taken into account when considering how the total amount due to B's estate is to be paid out.

(2) To credit the outgoing partner with a proportionate amount based on the profits disclosed by the last annual accounts of the partnership or on an average of the profits for a certain number of past years.

(3) To credit the outgoing partner with an additional percentage of interest on his last agreed capital, in lieu of profits.

The last two methods are preferable where an early settlement is desired and it is, therefore, not convenient to await the preparation of the next annual accounts.

REVALUATION OF ASSETS

Unless the partnership agreement provides otherwise, an outgoing partner (or his representative) is entitled to have all the assets of the firm brought into account at a fair value as at the date of dissolution. If the proper principles have been followed in keeping the partnership books and preparing the annual accounts, floating assets such as stock-in-trade and book debts will have been brought into account at the correct value—the lower of cost or market price.

The outgoing partner cannot claim that the stock ought to be revalued at selling price where, as is usual, that is in excess of cost, for the goods have not yet been sold and a profit is not earned until they are sold. Proper provisions should be made for bad and doubtful debts, and if this is done and the figures are agreed by all the interested parties, the settlement cannot afterwards be reopened on the ground that the provision has proved inadequate or excessive, as the case may be.

Fixed assets such as buildings, plant and machinery, on the other hand, will have been dealt with in the firm's books on a going-concern value basis, their original cost being written off by regular annual charges for depreciation. It may happen that the current realizable value of a fixed asset is very different from its book value. While the old partnership continued this was of no importance. The fixed assets were held for use in the business and not for realization. When a fixed asset is sold, however, any profit or loss on realization, as compared with its book value, is divisible between the partners in the same ratio as ordinary trading profits or losses are shared.

Indeed, in ordinary circumstances such profit or loss on realization would be brought into the Profit and Loss Account for the year and would then become merged in the trading profits. It is, in effect, merely a correction of the amounts previously charged in the Profit and Loss Account for depreciation.

At the date of dissolution, therefore, it may be necessary to revise such of the book values of the fixed assets as are not in line with current values. If this is not done, and a fixed asset is in fact sold soon after one of the partners has retired, the resulting profit or loss would accrue to or be borne by the continuing partners alone, which would not be equitable. Nevertheless, partnership agreements frequently provide that no revaluation is to be made but the last Balance Sheet values are to be binding on the partners.

Where revaluation is necessary it can be brought about either by transferring the appropriate amount from the asset account to the Capital Accounts of all the partners in their profit-sharing ratio or the outgoing partner's share of the adjustment can be calculated and transferred from his account to the Capital Accounts of the continuing partners.

This second method is followed where it is not desired to disturb the book value of the asset and is in accordance with the sound principle that fixed assets should be recorded at cost less depreciation until such time as they are actually sold. It should not be used, however, where the surviving partners are proposing to enter into a new partnership agreement under which they will not share profits in the same way as before.

Example (*continued from page* 164)

The book value of the business premises owned by A, B and C at the date of B's death was £5,000, while the Sales Ledger balances (Sundry Debtors) totalled £1,800. It was agreed that for the purpose of settling accounts with B's Executors:

(1) The premises were to be valued at £6,500, but this value was not to be written into the books.

(2) A Provision for Bad and Doubtful Debts equal to 10 per cent of the book debts on September 30 was to be made.

The journal entries to record these two adjustments will be as follows:

			£	£
19—				
Sept. 30	A, Capital A/c	Dr.	375	
	C, Capital A/c		125	
	To Executors of B A/c,			500
	being B's share of agreed appreciation in value of business premises, written off to A and C in their profit-sharing ratio:			
		£		
	Agreed valuation	6,500		
	Book value	5,000		
	Profit on revaluation	£1,500		
Sept. 30	A, Current A/c	Dr.	90	
	C, Current A/c		30	
	Executors of B A/c		60	
	To Provision for Bad and Doubtful Debts			180
	being provision created as per agreement with B's Executors.			

Note. In the first entry the debits are made in the Capital Accounts of A and C—not in their Current Accounts—because this adjustment in the valuation of a fixed asset does not affect the liquid resources of the firm which determine the amounts that A and C are entitled to for undrawn profits to date. In the second entry, on the other hand, the Provision for Bad Debts is, in effect, a reduction in the liquid resources of the firm and the Current Accounts of A and C are, therefore, debited.

GOODWILL

Even if the partnership agreement rules out any question of revaluing fixed assets it will generally provide that an outgoing partner is to be credited with his share of the firm's goodwill. It is desirable that the

agreement should define the way in which the value is to be calculated; if it does not do so it will have to be agreed.

The general principles governing all goodwill adjustments in partnership accounts have already been considered in Chapter IX. The outgoing partner's share of the agreed total value of the goodwill is calculated in his profit-sharing proportion; it can be dealt with in the following ways:

(1) If there is no existing Goodwill Account:

(*a*) A Goodwill Account can be opened, each partner, including the outgoing partner, being credited with his share of the agreed value.

(*b*) The outgoing partner's share can be credited to him and debited to the continuing partners in their profit-sharing ratio, provided that, as between themselves, they continue to share profits in that ratio.

(2) If there is an existing Goodwill Account it will probably record goodwill at what it cost the partnership when it was purchased many years ago; or, alternatively, it may stand at the value agreed upon at the last previous change in the partnership. In such a case the book value of goodwill should be written up or down, as the case may be, to the value now agreed, each partner being credited or debited with his proportion of the entry, in the ratio in which profits have been shared immediately before the change in the firm.

Example (*continued from page* 160)

Goodwill stood in the books of A, B and C at £3,000, which was the price paid for it when the partnership was formed many years previously. The partnership agreement provides that on the death or retirement of a partner goodwill is to be revalued at three years' purchase of the average profits for the past five years before charging partners' salaries or interest on capital.

The profits for the five years preceding B's death were:

	£	
	2,000	
	3,000	
	2,500	
	3,500	
	4,000	
Total for five years	£15,000	
Average	£3,000	
Value of goodwill	9,000	being three years' purchase of the average profits.
Book value of goodwill	3,000	
Appreciation in value	£6,000	of which B is entitled to be credited with a third share = £2,000.

The journal entry to give effect to this adjustment will be:

			£	£
19—				
Sept. 30	Goodwill	Dr.	6,000	
	To A, Capital A/c			3,000
	C, Capital A/c			1,000
	Executors of B A/c,			2,000
	being additional value of goodwill calculated according to the partnership agreement.			

(3) If, under the partnership agreement, goodwill is not to be valued but is to be ignored or, where it already stands in the books at that value, is to be regarded as worth its book value, then no adjustment will be necessary on the death or retirement of a partner. It must be emphasized, however, that in the absence of a clear agreement to this effect a retired partner or the representatives of a deceased partner are always entitled to have goodwill brought into account at a fair value.

PAYMENT OF THE OUTGOING PARTNER'S SHARE

As the effect of all the foregoing adjustments will generally be to increase rather than to diminish the value of the outgoing partner's capital in the firm, which is now due to be repaid to him, it may well happen that an immediate payment in cash of the whole sum would be very inconvenient, if not impossible.

Partnership agreements, therefore, frequently provide that when the total sum due has been ascertained it shall be paid by a certain number of yearly or half-yearly instalments, with interest on the outstanding balance. Even if the original partnership agreement does not so provide, the same result may be achieved by agreement between the continuing partners and the retired partner or the representatives of a deceased partner, as the case may be.

Example (*continued from page* 167)

The partnership agreement between A, B and C provided that the amount found to be due to a retired or deceased partner should be paid by four equal annual instalments commencing on the anniversary of the date of death, with interest at 5 per cent per annum on the balances outstanding.

The account for B's Executors in the books of A and C, after giving effect to the various adjustments already considered and after the amount due has been paid over on the first anniversary of B's death, will be as follows:

19—			£	19—			£
Sept. 30	To Provision for Bad Debts		60	Sept. 30	By B, Capital A/c		4,000
					B, Current A/c		1,360
	Balance	c/d	7,800		Sundries (share of appreciation of business premises)		500
					Goodwill A/c		2,000
			£7,860				£7,860
				Oct. 1	By Balance	b/d	7,800
(1 yr. later) Sept. 30	To Cash ($\frac{1}{4}$ of £7,800 = £1,950; Interest £390		2,340	(1 yr. later) Sept. 30	Profit and Loss A/c—Interest at 5% p.a.		390
	Balance	c/d	5,850				
			£8,190				£8,190
				Oct. 1	By Balance	b/d	5,850

SETTLEMENT IN THE ABSENCE OF AGREEMENT

When there is no agreement to pay out a deceased or retired partner by instalments the amount due must be ascertained and paid out as soon as possible. An immediate settlement would not normally be possible, and in such cases it may be necessary to invoke the following provision of Section 42 of the Partnership Act:

"(1) Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with its capital or assets without any final settlement of accounts as between the firm and the outgoing partner or his estate, then, in the absence of any agreement to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to (i) such share of the profits made since the dissolution as the Court may find to be attributable to the use of his share of the partnership assets, or (ii) to interest at the rate of five per cent per annum on the amount of his share of the partnership assets.

"(2) Where the partnership agreement has given an option to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and the option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account in the manner set out above."

It will be observed that the aggrieved party is, by sub-section (1), given the option of claiming interest on his share of the partnership assets (that is, the amount due to him for capital and undrawn profits after making such adjustments as are necessary and have been considered already) *or* a share of profits.

If he claims a share of profits in lieu of interest, however, it will be necessary to apply to the Court for the appropriate share of profits to be fixed. This share will not necessarily be the same as the share of profits enjoyed by the claimant while he was a partner; it is merely to be such share as in the Court's opinion is attributable to the continued use of his capital in the business.

As the other partners may be able to show that the profits of the firm are due primarily to the personal exertions of the partners rather than to the amounts of their capitals, it is generally simpler and safer to exercise the other alternative and claim 5 per cent interest in lieu of a share of profit. This course does not involve any application to the Court.

COMPLETE DISSOLUTION

When a partnership is dissolved and there is no agreement that the business is to be continued by one or more of the former partners, then the assets must all be realized to the best advantage. This applies particularly to goodwill. If goodwill is sold the purchaser will acquire the right to represent himself as succeeding to the business.

This will make it difficult for the former partners to carry on similar business in the same neighbourhood; it may, therefore, be the wish of some of them that the goodwill should not be sold but they should all be free to trade on their own account. Unless all agree to this, any dissentient partner can insist that the goodwill be sold.

SALE AS A GOING CONCERN

Where the goodwill is sold, it is possible that some or even all of the partnership assets will be sold with it. The business is then said to be sold as a going concern. Such a sale arises where partners decide to convert their business into a limited company, in which case they will probably take shares in the company in lieu of the cash that would otherwise be due to them. So far as the partnership accounts are concerned, the sale of the business to the company is a dissolution of the partnership and the same entries will be made in the partnership books as if the business had been sold to strangers.

The sale of all the assets brings the partnership to an end and it only remains to consider how the proceeds of realization ought to be shared. First, the profit or loss on realization must be calculated.

It has already been seen that there is no distinction in partnership law between capital profits or losses and ordinary trading profits or losses. The profit or loss on realization is, therefore, divisible between the partners in their ordinary profit-sharing ratio.

For the purpose of recording the transaction in the books a Realization Account is opened. This is debited with the book values of all the assets that have been sold (the corresponding credit entries in the asset accounts

having the effect of closing them) and credited with the purchase consideration for them. The balance representing profit or loss on realization is then transferred to the Capital Accounts of the partners in their profit-sharing ratio.

Example

The Balance Sheet of Alpha, Beta and Gamma on June 30 was as follows:

	£	£		£	£
Capital Accounts:			Goodwill at cost		1,500
Alpha	5,000		Freehold Premises at cost less depreciation		6,500
Beta	3,000		Fixtures and Fittings		1,000
Gamma	2,500	10,500	Stock-in-Trade		2,300
Current Accounts:			Sundry Debtors	1,800	
Alpha	550		Less Reserve for Bad Debts	180	1,620
Gamma	250	800	Current Account, Beta		300
Sundry Creditors		800	Cash in Hand		10
Bank Overdraft		1,130			
		£13,230			£13,230

Profits and losses are shared in the following proportions: Alpha four-tenths, Beta three-tenths, Gamma three-tenths.

It has been agreed that the business shall be sold to a limited company, United Greeks, Ltd., as from the date of the above Balance Sheet. The purchase price for the whole of the assets, including goodwill, is £15,000; £800 of this is to be met by the company assuming the liabilities to Sundry Creditors. The overdraft is not taken over.

The Realization Account in the books of the partnership will appear as follows:

	£	£		£
To Sundry Assets transferred:			By Bad Debt Reserve transferred	180
Goodwill		1,500	United Greeks, Ltd. Purchase considerations	15,000
Freehold Premises		6,500		
Fixtures and Fittings		1,000		
Stock-in-Trade		2,300		
Sundry Debtors		1,800		
Cash in Hand		10		
		£13,110		
Profit on Realization, transferred to partners' Capital A/cs:	£			
Alpha 4/10ths	828			
Beta 3/10ths	621			
Gamma 3/10ths	621	2,070		
		£15,180		£15,180

Notes. (1) The debit balance on Beta's Current Account (which presumably arises because his drawings have exceeded his share

of trading profits) is not an asset of the firm that would be transferred to the purchasing company. It merely offsets Beta's Capital Account and will be taken into account in calculating the amount due to him when the purchase consideration is divided.

(2) The effect of the above entries is to close all the accounts in the books with the exception of the partners' Capital and Current Accounts and the Cash Book (in which the bank overdraft is recorded). Pending payment of the £14,200 balance of the purchase consideration an account will be opened for the purchasing company. The Current Accounts will be closed by transfer to the Capital Accounts, which will then be as follows:

CAPITAL ACCOUNTS

	Alpha	*Beta*	*Gamma*		*Alpha*	*Beta*	*Gamma*
	£	£	£		£	£	£
To Current A/c transferred		300		By Balance b/f	5,000	3,000	2,500
				Current A/cs transferred	550		250
Balances c/d	6,378	3,321	3,371	Profit on Realization	828	621	621
	£6,378	£3,621	£3,371		£6,378	£3,621	£3,371
				By Balance b/d	6,378	3,321	3,371

The total of these balances is £13,070, which is equal to the balance of the purchase consideration £14,200 less the bank overdraft.

(3) If the balance of the purchase consideration is payable in cash the effect of paying it into the partnership bank account will be to discharge the overdraft and leave a balance which is the exact amount required to pay out the balances on the partners' Capital Accounts. If, however, the purchase consideration is payable either wholly or partly in some other form (for example, by an allotment of shares in the company) other considerations will arise. These are considered later.

SALE OF ASSETS SEPARATELY

If instead of selling their business as a going concern the partners merely decide to close the business and sell the assets piecemeal, a Realization Account will still be necessary, but the final closing of the books will be deferred until the last assets have been sold. The amount realized on sale of each asset will be credited to the appropriate asset account, which will then be closed by transfer to Realization Account. As the Realization Account in these circumstances merely collects together the profits and losses on sale of the assets it is more correctly known as a Profit and Loss on Realization Account.

Example

Alpha, Beta and Gamma, whose Balance Sheet on June 30 was as shown in the last example, decided to close down their business, which could no longer be carried on at a profit. They sold the freehold premises for £7,000, while fixtures and fittings realized £200 and the stock, sold at auction, fetched £1,600. The book debts were all collected in with the exception of three, amounting to £140, which had to be written off as wholly irrecoverable. Discounts amounting to £40 were allowed to those debtors who paid their accounts. Expenses of realization of the other assets amounted to £60.

Out of the proceeds of sale and realization they paid off their creditors at a discount of £20 and the bank overdraft and then drew up accounts to show the amount due to each partner, as follows:

PROFIT AND LOSS ON REALIZATION ACCOUNT

	£		£
To Goodwill, written off	1,500	By Bad Debt Reserve	180
Loss on sale of:		Profit on sale of Freehold Premises	500
Fixtures and Fittings	800	Discounts Received	20
Stock	700	Balance, Loss on Realization, c/d	2,540
Bad Debts	140		
Discounts Allowed	40		
Expenses of Realization	60		
	£3,240		£3,240
To Loss on Realization b/d	2,540	By Alpha, Capital A/c, 4/10ths	1,016
		Beta, Capital A/c, 3/10ths	762
		Gamma, Capital A/c, 3/10ths	762
	£2,540		£2,540

CASH BOOK

	Discount	*Bank*		*Discount*	*Bank*
	£	£		£	£
To Cash in Hand		10	By Bank Overdraft b/f		1,130
Proceeds of sale:			Expenses of Realization		60
Freehold Premises		7,000	Sundry Creditors	20	780
Fixtures and Fittings		200	Balance c/d		8,460
Stock		1,600			
Sundry Debtors	40	1,620			
	£40	£10,430		£20	£10,430
To Balance		8,460			

Capital Accounts

	Alpha	Beta	Gamma		Alpha	Beta	Gamma
	£	£	£		£	£	£
To Current A/c		300		By Balances b/f	5,000	3,000	2,500
Loss on Realization	1,016	762	762	Current A/cs	550		250
Balances c/d	4,534	1,938	1,988				
	£5,550	£3,000	£2,750		£5,550	£3,000	£2,750
				By Balance b/d	£4,534	£1,938	£1,988

Notes. (1) The amounts received from Sundry Debtors and paid to Sundry Creditors would, in fact, be entered in detail in the Cash Book to enable the appropriate postings to be made to the personal accounts in the Sales Ledger and Bought Ledger respectively. The three bad debts amounting to £140 are then written off by debiting Profit and Loss on Realization Account and crediting the three accounts concerned in the Sales Ledger. Both personal ledgers are thus closed off completely.

(2) Discounts Received and Allowed are recorded in the Discount columns of the Cash Book in the usual way, but as the business has been discontinued and there will be no more Trading and Profit and Loss Accounts to prepare, the Discount totals from the Cash Book are posted to the Profit and Loss on Realization Account.

(3) The bank overdraft is brought forward as a credit balance in the Cash Book and is automatically paid off when the proceeds of realization are paid into the bank account.

(4) Cash in hand is paid into the bank for the purpose of record and to enable it to be included in the final distribution to the partners.

(5) The final balances on the partners' Capital Accounts are seen to total £8,460, which is equal to the balance of cash at bank. As all the other ledger accounts have now been closed this acts, in effect, as a final Trial Balance of the books and shows how much should be paid to each partner on the final settlement.

APPLICATION OF PROCEEDS OF REALIZATION

Where there is any doubt as to the sufficiency of the partnership assets to meet all claims that may arise, it is necessary to consider the priority in which such claims ought to be settled. As every partner is individually liable, if necessary, to meet all the liabilities and obligations of the firm it is to be expected that the claims of a partner against the assets of the firm will rank after the claims of creditors. This is confirmed by the provisions of Section 44:

"In settling accounts between the partners after a dissolution of partnership the following rules shall, subject to any agreement, be observed:

"(*a*) Losses, including losses and deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly, if necessary,

by the partners individually in the proportion in which they were entitled to share profits.

"(*b*) The assets of the firm including the sums, if any, contributed by the partners to make up losses or deficiencies of capital, shall be applied in the following manner and order:

"(i) In paying the debts and liabilities of the firm to persons who are not partners therein.

"(ii) In paying to each partner rateably what is due from the firm to him for advances as distinguished from capital.

"(iii) In paying to each partner rateably what is due from the firm to him in respect of capital.

"(iv) The ultimate residue, if any, shall be divided among the partners in the proportion in which the profits are divisible."

The exact implication of some of the provisions of Section 44 is a little difficult to understand until it is remembered that those drafting the Act sought to cover, in one comprehensive section, a wide variety of circumstances that may arise upon dissolution of a partnership. In ordinary circumstances, such as have been considered in preceding examples, the partners' Capital Accounts remain in credit after debiting them with their respective shares of any loss on realization (or crediting them where there is a profit), and in such cases there are always sufficient funds both to pay off the creditors and to pay out the partners. The application of the section in such cases is only of academic interest.

The words "subject to any agreement" appearing in the opening paragraph mean, of course, agreement between the interested parties. Thus, in the first example, on page 171, the liabilities to Sundry Creditors were to be taken over by the company to which the business was sold. Such an agreement would only be binding upon the creditors if they individually consented to it; otherwise the partners must remain personally liable to meet their debts until such time as the latter are actually paid by the company.

In the second example, on page 173, the application of Section 44(*a*) is seen. Most of the assets were realized at a loss, but one—the freehold premises—yielded a profit. The losses on realization were met first out of this profit because all the figures were brought together in one Realization Account. The net loss on realization was then met out of capital because the balance of Realization Account was transferred to the partners' Capital Accounts.

As the loss was not sufficient to exhaust any of their balances the third alternative did not arise directly. It arose indirectly, however, because in the process of writing off the loss on realization the original capitals were diminished; these *deficiencies of capital* were borne by the partners in their profit-sharing ratio.

Section 44(*b*) is of importance only in that it fixes the order in which payments ought to be made if there is any doubt as to the ultimate sufficiency of assets to meet all claims. It should be noted that this section does not restrict a creditor's rights to obtain redress from the individual partners, if necessary. If, therefore, the partners were to pay

out their own capitals before meeting the claims of creditors, and as a result the partnership funds were insufficient to pay the creditors in full, this clearly would constitute a contravention of Section 44; it would not, however, give the injured creditor any greater right of action than he in fact enjoys already, for he always has been entitled to sue any one of the partners (or some or all of them, jointly) for the amount due to him.

Nevertheless, partnership affairs are conducted on the basis that the claims of creditors will be met out of the partnership assets rather than out of the individual estates of the partners. The provisions of Section 44 should, therefore, always be applied literally where there is any doubt at all as to the ultimate outcome of the realization.

ASSETS TAKEN OVER BY PARTNERS

It may sometimes happen that after a dissolution of partnership it is not possible or not convenient to convert all the assets into cash in order to enable a final settlement of accounts to be made between the partners. There are two types of case to be considered.

One partner at his own request may take over some of the assets of the firm at agreed values because he is proposing to carry on a similar business on his own account, or he may agree to take over an asset or assets because there is no immediate prospect of selling them at a reasonable price.

The accounting principles involved in such cases will be similar to those already applied where the assets were, in fact, sold to third parties. The asset has been realized (at an agreed price) and the Realization Account will, therefore, be credited with the agreed price, but the corresponding debit entry will be in the Capital Account of the partner who has taken over the asset and not in the Cash Book.

There is no reason why the partner should pay in cash in respect of such a transaction when there is, in fact, a substantial amount due to him for capital; if, however, he takes over values in excess of his Capital Account balance, he will have to pay in the difference.

Example

The Balance Sheet of Black, White and Green on September 30 was as follows:

BALANCE SHEET as on September 30

		£		£
Capital A/cs:			Freehold Premises at cost	2,350
Black	£2,206		Plant and Equipment at cost,	
White	963		less depreciation	582
Green	1,219		Investment in Brown, Ltd.,	
		4,388	at cost	1,000
			Stock	1,263
Sundry Creditors		1,681	Sundry Debtors	821
			Cash at Bank	53
		£6,069		£6,069

Profits and losses are shared equally. The partnership is dissolved on September 30, White, who carries on a similar business in a neighbouring town, agreeing to take over the plant and equipment at a valuation of £550 and stock at £1,200. The book debts realize £780 and the freehold premises were sold for £2,500. Legal expenses in connexion with the foregoing amounted to £41.

It is not possible to find a purchaser of the investment in Brown, Ltd.; Black, therefore, agrees to take over these shares at their book value, £1,000.

The books of the partnership will be closed as follows:

REALIZATION ACCOUNT

	£	£		£	£
To Plant and Equipment:			By Freehold Premises:		
Book value	582		Proceeds of Sale	2,500	
Less agreed value on transfer to White	550		*Less* Book value	2,350	
		32			150
Stock:			Investment in Brown, Ltd.	1,000	
Book value	1,263		*Less* transfer to Black at book value	1,000	
Less agreed value on transfer to White	1,200				
		63	Loss on Realization:		
Book Debts	821		Black	9	
Less Amounts collected	780		White	9	
			Green	9	
		41			27
Legal Expenses		41			
		£177			£177

CASH BOOK

		£			£
To Balance	b/f	53	By Legal Expenses		41
Freehold Premises		2,500	Sundry Creditors		1,681
Book Debts		780	Balance	c/d	1,611
		£3,333			£3,333
To Balance	b/d	1,611	By Black		1,197
White		796	Green		1,210
		£2,407			£2,407

CAPITAL ACCOUNTS

	Black	White	Green		Black	White	Green
	£	£	£		£	£	£
To Loss on Realization	9	9	9	By Balances b/f	2,206	963	1,219
Assets transferred at agreed values:							
Plant and Equipment		550					
Stock		1,200					
Shares in Brown, Ltd.	1,000						
Balances c/d	1,197		1,210	Balance c/d		796	
	£2,206	£1,759	£1,219		£2,206	£1,759	£1,219
To Balance b/d		796		By Balances b/d	1,197		1,210
Cash	1,197		1,210	Cash		796	
	£1,197	£796	£1,210		£1,197	£796	£1,210

Where part of the purchase consideration has been received in a form other than cash and there is no special agreement as to how this part of the consideration is to be dealt with, each partner will have to take a share of it as part of the balance due to him. Similarly, where some of the existing assets of a partnership are incapable of realization for the time being, the only way in which the partnership can be finally dissolved will be for such assets to be taken over by some or all of the partners.

If it is not possible to reach agreement on the values at which such transfers are to be effected, or as to the amounts to be taken over by each partner, it is necessary to bear in mind that any ultimate profit or loss on realization ought to be shared by or borne by the partners in their profit-sharing ratio. This result can only be achieved if assets that are of doubtful value are transferred to the partners in their profit-sharing ratio.

The same principle ought to be followed where part of the consideration for the sale of a partnership business as a going concern consists of shares in a limited company. Until the company proves its worth it may be almost impossible to assess the true value of the shares, which may be very different from their nominal or face value (that is, the amount credited as paid up on them). In such circumstances the shares ought to be taken over by the partners in their profit-sharing ratio, the remaining balances on their Capital Accounts then being cleared by cash settlements.

Example (*continued from page* 171)

If the purchase consideration for the sale of the business to United Greeks, Ltd., was made up as follows:

	£
Assumption of liability to creditors	800
Shares in United Greeks, Ltd. (nominal value)	10,000
Cash	4,200
	£15,000

the books of the partnership will be closed as follows:

UNITED GREEKS, LTD.

	£		£	£
To Realization A/c	15,000	By Sundry Creditors		800
		Cash		4,200
		Partners' Capital A/cs for shares allotted:		
		Alpha	4,000	
		Beta	3,000	
		Gamma	3,000	
				10,000
	£15,000			£15,000

CAPITAL ACCOUNTS (*continued*)

	Alpha	*Beta*	*Gamma*		*Alpha*	*Beta*	*Gamma*
	£	£	£		£	£	£
To Shares in United Greeks, Ltd.	4,000	3,000	3,000	By Balances b/d	6,378	3,321	3,371
Cash	2,378	321	371				
	£6,378	£3,321	£3,371		£6,378	£3,321	£3,371

CASH BOOK

	£			£	£
To United Greeks, Ltd.	4,200	By Bank Overdraft	b/d		1,130
		Alpha		2,378	
		Beta		321	
		Gamma		371	
					3,070
	£4,200				£4,200

Where one partner has a comparatively small amount of capital in the firm, or the loss on realization is very large, or the original capitals have been depleted by heavy trading losses, one or more of the Capital Accounts may show a debit balance when all the closing entries have been made. Unless these balances can be made good by the partner or partners concerned bringing in cash it will not be possible to pay out in full those partners whose accounts are still in credit.

A partner whose Capital Account shows a debit balance is, of course, liable to the full extent of his private resources to make good this balance, which is a debt due from him to his co-partners. If he is unable to make it good because he has not any or sufficient private assets he is to that extent insolvent. Whether or not his partners pursue the matter to the point of making him bankrupt, they will not receive the whole amount due to them; it is necessary to consider how the resulting loss is to be shared. (If there were originally only two partners, the whole of the loss necessarily falls upon the one who is solvent and the point does not arise.)

It was decided in 1903 in the case of *Garner* v. *Murray*, which is well known to students of accountancy but is not otherwise of much practical importance, that such a loss ought to be shared by the other partners in the ratio of their last agreed capitals. This is, therefore, the only exception to the rule that all partnership profits and losses are shared in the ratio that has been agreed for the division of ordinary profits or losses.

Example

The capitals of Adams, Benson and Cruikshank at the date of dissolution of their partnership were £5,000, £3,000 and £500 respectively. Undrawn profits due to them were: Adams £500 and Benson £300. Cruikshank had overdrawn his Current Account by £300. Profits were shared equally. There was a loss on realization of £2,400. Cruikshank was unable to meet any part of the balance due from him.

The amounts due to the partners out of the proceeds of realization will be calculated in the following way:

CAPITAL ACCOUNTS

	Adams	*Benson*	*Cruikshank*		*Adams*	*Benson*	*Cruikshank*
	£	£	£		£	£	£
To Current A/c transferred			300	By Balances b/f	5,000	3,000	500
Loss on Realization	800	800	800	Current A/cs transferred	500	300	
Balances c/d	4,700	2,500		Balance c/d			600
	£5,500	£3,300	£1,100		£5,500	£3,300	£1,100

	£	£	£		£	£	£
To Balance b/d			600	By Balances b/d	4,700	2,500	
Cruikshank's deficiency per contra	375	225		Cruikshank's deficiency transferred to Adams and Benson in ratio of their last agreed capitals, £5,000 : £3,000			
Cash	4,325	2,275		Adams			375
				Benson			225
	£4,700	£2,500	£600		£4,700	£2,500	£600

Notes. (1) When the net balance due from Cruikshank has been calculated (£600) it is divided between Adams and Benson in the ratio of their last *agreed capitals*. These are the balances on their Capital Accounts, £5,000 and £3,000 respectively, *before* transferring their Current Account balances and before debiting them with their shares of the loss on realization.

(2) As the Capital Account balances totalled £8,500, while the Current Accounts together showed a net credit balance of £500 (£500 + £300 − £300), the net assets (that is, assets less liabilities) must have amounted to £9,000. As there was a loss on realization of £2,400, the amount of cash available is £6,600. Of this Adams will get £4,325 and Benson £2,275.

QUESTIONS AND EXERCISES

(Key to answers on page 570)

(1) A and B, trading in partnership and sharing profits and losses in the proportion of two-thirds and one-third respectively, sold their business to XY & Co. The Balance Sheet of A and B was as follows:

	£		£
Creditors	3,750	Plant	2,000
Capital—A	6,000	Fixtures and Fittings	650
B	4,000	Stock	7,500
		Debtors	2,500
		Bills Receivable	500
		Cash at Bank	600
	£13,750		£13,750

The purchasers agreed to give £2,000 for goodwill, but would only take over the Stock at £7,000 and Plant at £1,700.

Make up the Capital Accounts of A and B to show the amounts due to A and B respectively. (*L.C. of C. Certificate*).

(2) C and D are in partnership as merchants, sharing profits and losses as to two-thirds to C and one-third to D. On December 31 the undermentioned Balance Sheet was agreed between them:

	£	£		£	£
Capital Accounts:			Goodwill		1,000
C	5,000		Freehold Premises		1,500
D	3,000		Debtors	2,000	
		8,000	Less Provision for Bad Debts	250	
Creditors		1,000			1,750
			Stock		4,000
			Bank Balance		750
		£9,000			£9,000

As from December 31 they dissolved partnership, with the following results:

(*a*) C took over the freehold premises as part of his share (no cash passes) at a valuation of £1,200.

(*b*) The goodwill proved valueless.

(*c*) The debtors realized £1,900.

(*d*) The stock was sold for £3,900.

(*e*) The creditors were paid off subject to a discount of $2\frac{1}{2}$ per cent.

(*f*) It was agreed that D should be entitled to £50 for his trouble in managing the winding-up.

You are required to produce such accounts as will display the final amount received by each partner. You need not open separate accounts for the assets. (*R.S.A. Stage II*).

(3) Long and Short, who were partners sharing profits equally, agreed to dissolve partnership on December 31, when the following was their agreed Balance Sheet:

	£	£		£	£
Capital Accounts:			Plant and Machinery		1,583
Long	4,000		Stock-in-Trade		5,211
Short	3,000				
		7,000	Debtors	2,724	
Long: loan to firm	1,000		Less Provision for Bad Debts	250	
Interest thereon	50				2,474
		1,050	Bank Balance		782
Creditors		2,000			
		£10,050			£10,050

The creditors were settled with for £1,850. The Plant and Machinery was sold for £1,300. Part of the Stock-in-Trade was taken over as at the value of £1,000 by Long as part of his ultimate share, and the balance was sold for £4,000. The Debtors realized £2,500 net.

Without giving accounts for the individual assets and liabilities, prepare such accounts as are necessary to show the result of the winding-up and the amount ultimately received by each partner. (*R.S.A. Stage II*).

(4) Andrews, Brown and Jones are in partnership, sharing profits in the proportions of 3 : 3 : 2.

Andrews retired on March 31, the firm's Balance Sheet immediately before the retirement being as follows:

	£	£		£
Capital Accounts—			Goodwill	3,600
			Fixed Assets	9,600
Andrews	12,000		Stock	5,600
Brown	5,000		Debtors	3,721
Jones	4,000		Cash	396
		21,000		
Creditors		1,917		
		£22,917		£22,917

Andrew's share of the goodwill, valued in accordance with the partnership agreement, was found to be £1,800.

On April 1 Smith joined the firm as a partner, bringing in £2,000 in cash, and for the purpose of the new partnership the Goodwill Account was to be written up to £4,700 before Smith's entry.

At the same time, Brown and Jones each brought in £3,000 in cash and Andrews withdrew £7,000, leaving the balance of his share as a loan to the firm.

Draw up the Balance Sheet of the firm after the above transactions have been completed. (*L.C. of C. Higher*).

(5) Evans and Smith were trading in partnership, sharing profits and losses in the proportion of 3 to 2. The firm's Balance Sheet, drawn up as on December 31, was as follows:

	£	£		£	£
Capital Accounts:			Goodwill		1,000
Evans	16,000		Furniture and Fittings		800
Smith	4,000		Stock		16,240
		20,000			
Current Account, Evans		560	Debtors	2,590	
Sundry Creditors		1,170	Less Reserve	50	
					2,540
			Current Account, Smith		220
			Cash at Bank		930
		£21,730			£21,730

The partnership was dissolved on January 1, Evans retiring from business and Smith taking over one of the two shops owned by the firm; the other shop was sold. The assets taken over by Smith were valued by agreement as follows:

Goodwill	£1,500
Furniture and Fittings	550
Stock	8,330

Smith also took over the whole of the debtors, subject to an allowance of £130 to cover possible bad debts and the trouble of collection, and undertook to pay the creditors.

The goodwill, furniture and stock at the other shop was sold for the inclusive figure of £10,970, settled in cash. Cash due by or to either partner was paid into or out of the firm's bank account and the books of the firm were closed, Smith opening a new set of books.

You are required to show the Realization Account and the closing entries in each partner's Capital Account and in the Cash Book. (*R.S.A. Stage III*).

(6) A, B and C were in partnership, sharing profits and losses as to one-quarter to A, one-eighth to B and five-eighths to C, but prior to the division of profits B and C were each to be credited with a salary of £500 per annum. The accounts of the firm were made up annually to September 30, and the profit for the year, to September 30, 1949, was £2,640 prior to charging partners' salaries.

A became bankrupt on March 31, 1949, but B and C continued in partnership, sharing profits and losses in the same relative proportions as before. No settlement was made with A or with his trustee in bankruptcy until the close of the financial year on September 30, 1949, when the trustee claimed, and was allowed, interest at 5 per cent per annum on the amount due to him.

The partnership agreement did not provide for any interest upon capital or upon drawings. Drawings during the year to September 30, 1949, were A £500, B £600 and C £900. A's capital was £5,000 on September 30, 1948, and had not changed by the date of his bankruptcy.

You are required to show the division of the profit, the partners' Current Accounts and the amount which was due to A's trustee in bankruptcy, assuming that the profits accrued evenly over the year. (*R.S.A. Stage III*).

(7) Two partners, Rhode and Cresset, having decided to discontinue business, sold the stock, machinery and plant and the goodwill to Worfield, Ltd., for £12,000 cash and 12,000 shares of £1 each in the company, the market quotation being £1 10s. per share. The partners collected the debts and paid off the liabilities of their own business.

At the date of sale the partners drew up their Balance Sheet as follows:

	£		£
Due to Rhode	16,230	Cash at Bank	630
Due to Cresset	12,000	Debtors	14,400
Loan—Rhode	2,400	Machinery, etc.	6,000
Creditors	7,200	Stock	16,800
	£37,830		£37,830

The debts were all collected, with the exception of £550 which was irrecoverable, and £350 discounts allowed. The creditors were paid without any deduction. The partners shared profits and losses as to Rhode two-thirds and Cresset one-third, and it was agreed in the final settlement that Rhode should take the whole of the shares in Worfield, Ltd., in part payment of his share.

Prepare an account showing how the cash available will be allocated between the partners. (*A.C.C.A. Inter.*).

(8) James, Henry and Peter were in partnership, making up accounts annually to December 31. James died on June 30, 1948, having by his Will bequeathed his capital in the firm equally to the surviving partners, free of Legacy Duty, subject to their undertaking to pay an annuity of £500 per annum to his (James's) widow.

Henry and Peter gave the required undertaking and continued in partnership and arranged to pay the annuity quarterly. James's capital amounted to £5,560. This money being required in the business as working capital the amount was transferred to a Capital Suspense Account, opened for the purpose, to which interest at the rate of 4 per cent per annum calculated on the quarterly balance was credited and against which the annuity payments were charged. James's widow died on December 31, 1949.

Show the Capital Suspense Account in detail as it would appear in the firm's books, and the division of the balance between the partners.

Ignore Income Tax, and show your figures in pounds to one decimal place. (*Chartered Accountants, Inter.*).

(9) X, Y and Z are partners sharing profits equally. The firm's Balance Sheet is as follows:

	£		£
Capital Accounts:			
X	20,000	Machinery	7,000
Y	10,000	Stock-in-Trade	11,000
Creditors	5,000	Debtors	12,000
		Capital Account, Z	5,000
	£35,000		£35,000

They resolve to wind up and they dispose of the assets for £19,000. Costs of realization £1,000. Following the decision in *Garner* v. *Murray*, you are required to close the accounts of the partnership. (*Incorporated Accountants, Final.*)

(10) John and Henry are trading in partnership, owning three shops, A, B and C, and sharing profits in the proportion of 3 to 2. The following is the firm's Balance Sheet drawn up as on October 31:

	£	£		£	£
Capital Accounts:			Goodwill		1,700
John	16,080		Fixtures and Fittings		2,330
Henry	7,365		Motor Vehicles		1,270
		23,445	Stock		14,240
Sundry Creditors		2,375		£	
			Sundry Debtors	4,810	
			Less Provision	50	
					4,760
			Cash		1,520
		£25,820			£25,820

On November 1 the partnership was dissolved on the terms set out below:
John retired from business; Henry took over shops A and B; shop C was sold for £6,080, made up as follows:

	£
Goodwill	1,100
Fixtures and Fittings	650
Stock (at Balance Sheet valuation)	4,330
	£6,080

This amount was settled by the purchaser in cash.

Henry took over all the remaining assets of the firm and assumed responsibility for the liabilities, the assets being valued as follows:

	£
Goodwill of shops A and B	2,700
Fixtures and Fittings of shops A and B	2,050
Motor vehicles	1,150
Stock, at Balance Sheet valuation	

Debtors, at book value subject to a total deduction of £160 to cover the cost of collection and possible bad debts.

John left £11,000 in the business by way of loan to Henry, the balance due being settled in cash. Henry kept open the books of the partnership and continued to use them as his own books.

Set out the Cash Book and ledger entries recording the above transactions. (*Chartered Accountants, Inter.*)

CHAPTER XI

PRINCIPLES OF COMPANY LAW

THE present company system may be said to have its origin in the Joint Stock Companies Act of 1844. Before that, trade was mostly carried on by individuals (that is, sole traders) or by partnerships in which the individual partners retained their identity and were fully responsible for the debts and obligations of the firm. There were, however, a few large corporations set up either by Royal Charter or by special Act of Parliament.

Three famous corporations or companies of this type were the East India Company (1600), the Hudson's Bay Company (1670) and the Bank of England (1694). These and other similar undertakings were obviously unsuitable to be constituted as partnerships and they also possessed an element of national interest which made the granting of a Royal Charter or the promotion of a special Act of Parliament desirable.

HISTORICAL DEVELOPMENT

As ordinary commercial undertakings tended to grow in size, the need of some new method of incorporation became obvious. Traders could not be expected to join together in partnerships in which each of perhaps a hundred partners would remain personally liable for debts which might amount to many thousands of pounds. Nevertheless, it cannot be said that limitation of liability was the prime motive leading to the formation of Joint Stock Companies, for the Act of 1844, while it provided for the incorporation and winding-up of companies and for the transfer of a member's share or shares to another person, did not limit the liability of the members.

The important principle of limited liability was first introduced in 1855. This made it possible (but not essential) to register a company in which the liability of each member would be limited to the amount he had paid, or agreed to pay, for his shares. This limitation of liability was indicated by the inclusion of the word Limited in the name of the company.

There is, perhaps, a tendency to refer to companies as "limited companies" as though limitation of liability of the members were an essential condition. In fact, it is still possible to form (under the Companies Acts) an unlimited company in which every shareholder is as fully responsible for the debts of the company as though he were a member of a partnership.

Up to 1908 all companies were of the type which is now known as a public company. The Companies (Consolidation) Act of 1908 made it possible to incorporate a company with as few as two members. The shares in such companies could not be offered for public subscription, so the new type of company was known as a private company, and because of the restricted nature of its membership, it enjoyed certain privileges

in regard to publishing its accounts. As a result, many comparatively small businesses which would otherwise have been conducted as partnerships have been incorporated as private limited companies, of which there are now many hundreds of thousands on the register.

The next Act of importance was the Companies Act, 1929. In addition to making a large number of small amendments, this made possible the issue of Redeemable Preference shares and contained important provisions regarding matters to be disclosed in prospectuses and in the annual accounts of companies. The holding and subsidiary company system first received legal recognition in this Act, in the form of an obligation to disclose certain information in the Balance Sheets of the holding company.

The last link in the chain, so far as it is at present constituted, is the Companies Act, 1948. This resulted from the Report of a Committee, set up in 1943 under the chairmanship of Mr. Justice Cohen (and for that reason often referred to as the Cohen Report), "to consider and report what major amendments are desirable in the Companies Act, 1929, and in particular, to review the requirements prescribed in regard to the formation and affairs of companies and the safeguards afforded for investors and for the public interest."

The immediate result of the completion of this Report was the passing of the Companies Act, 1947, which was an Act to amend and extend the existing law. The 1947 Act is, perhaps, most noteworthy for its very complicated and far-reaching provisions regarding the presentation and auditing of the annual accounts of companies. The recommendations of the Cohen Committee in regard to nominee shareholdings have not, as yet, been adopted.

The 1948 Act consolidates the provisions of the 1929 Act, as amended, and the new provisions of the 1947 Act and is thus the only Companies Act in force at the present time.

CORPORATIONS

Two types of corporation are known to the law: corporations sole and corporations aggregate. A corporation sole is a public office which is held by an individual in whom certain powers are vested by virtue of his office. The holders of such an office may die or, in some cases, retire, but the office itself continues and becomes vested in another. The corporation acts under its seal in order to distinguish the acts of the holder of the office, as such, from his personal acts and is said to enjoy perpetual succession. The highest office of this character is that occupied by the King. "The King is dead, long live the King!" is no more than a simple expression of this important legal and constitutional principle.

A corporation aggregate, on the other hand, represents the vesting of corporate powers in the hands of a number of persons. Such a corporation also acts under its seal and enjoys perpetual succession. Companies incorporated under the Companies Acts are corporations of this kind and many of the fundamental principles of company law are merely a special application, to this form of corporation, of the general common law rules. There are, however, many other corporations which function

in the commercial world, of which those most commonly encountered are as follows:

(1) Companies incorporated by special Act of Parliament or by Royal Charter, such as have been referred to already.
(2) Industrial and provident societies, which are incorporated under the Industrial and Provident Societies Acts but are more commonly known as co-operative societies.
(3) Friendly societies and building societies, incorporated under the Friendly Societies Acts and Building Societies Acts respectively. Some friendly societies, however, are unincorporated bodies.
(4) Public utility concerns, such as railway, gas and electricity concerns, which were created in the first instance by a special Act of Parliament and were also subject to such provisions of the Companies Clauses Acts, the Railways Acts, the Gas Works Clauses Acts and the Electricity (Supply) Acts as might be appropriate. In the process of nationalization of such concerns, however, these provisions will cease to have more than an historic interest.

Companies which fall under the foregoing headings are not incorporated under the Companies Acts and are not subject to their provisions. When dealing with a company, therefore, care must sometimes be exercised in deciding whether it is registered under the Companies Acts or not. The inclusion of the word Limited in the name of the company is evidence that it is registered under either the Companies Acts or the Industrial and Provident Societies Acts. If registered under the latter it is referred to as a "society" and the word Co-operative usually enters into its name. As already indicated, not all companies registered under the Companies Acts are limited companies, however, so the omission of the word Limited does not decisively denote that the Companies Acts do not apply.

Any reference in this book to a company must be taken as meaning one registered under the Companies Acts unless the contrary is clearly indicated. Further, such a company will be a "company limited by shares" unless the context otherwise demands.

REGISTRATION OF COMPANIES

A company is incorporated, or brought into being, by the action of the Registrar of Companies, who issues a Certificate of Incorporation. The procedure necessary to obtain such a certificate is considered later.

The Registrar of Companies is an official of the Companies Registration Department of the Board of Trade. There are at present two Companies Registration Offices—in London and Edinburgh respectively. The Registrar is concerned not only with the registration of new companies but also has to receive and file the various returns which all existing companies are required to make under the various provisions of the Acts.

A file is opened for each company and contains all the papers and returns registered by a company both in the course of and subsequent to its incorporation. This file is open to inspection by members of the public upon payment of a small fee (at present 1s.), during normal business hours.

The requirements as to registration of various documents and the

facilities afforded for inspection ensure that many important facts relating to every company are, in effect, published to the world at large. The degree of publicity, however, varies according to whether the company is a public or a private one.

The original registration of a company fixes its *domicile*, which may be either in England (including Wales) or in Scotland. Companies domiciled in Northern Ireland are subject to the Companies Acts of that country and are not further considered here. As between England and Scotland the importance of domicile is that it settles the law to which the company will be subject.

Most of the provisions of the Companies Acts are of equal application in the two countries, but in a few cases special provision is made. In addition, a company registered in Scotland will, in its relations with the outside world, normally be subject to Scots Law, which differs substantially from the common law of England.

LIMITED AND UNLIMITED COMPANIES

Limited liability implies that a member of a company may become liable for its debts and obligations up to but not beyond a certain point. This limitation is achieved in either of two ways:

(1) In a *company limited by shares* the liability of each member is limited to the amount for the time being unpaid on the shares which he holds. Once he has paid in full for these shares, which are then said to be fully paid, he cannot be under any further personal liability. The practical effect of this is that a person who invests money in the shares of a company may lose the amount of his investment if the company fails but he cannot be called upon to contribute towards the claims of creditors unless his shares are only partly paid. In the latter event he would be liable to pay into the company a sum not exceeding the amount necessary to make the shares fully paid.

(2) In a *company limited by guarantee* each member undertakes to contribute up to a certain amount (usually comparatively small) if the company has to be wound up and has not sufficient assets to meet its engagements.

If the company is formed in order to carry on a business, a certain amount of share capital will usually be required in order to finance it; such companies are, therefore, normally of the limited-by-shares type. On the other hand, clubs, professional associations and similar bodies which require corporate status frequently register as limited by guarantee. Such companies are normally financed by the entrance fees and annual subscriptions of their members and the guarantees will be invoked only in exceptional circumstances when liabilities have been incurred which cannot be met in any other way.

In the event of the liability of the members not being limited in one of the foregoing ways, then their liability will be unlimited. Such a company usually has a share capital, and while the company continues in existence a member's liability is in fact limited to the nominal value of the shares which he has taken or agreed to take. In the event of liquidation, however, further calls may be made from all members, in proportion to their

respective holdings, without limit, until sufficient funds are obtained to meet all the company's liabilities.

The principal function of the unlimited company is to meet the wishes of those who require a corporate body, with the resulting advantages of perpetual succession, transfer of shares on a member's death or otherwise, and so on. The business which is to be carried on may be one which it is undesirable or even impracticable to clothe with limited liability, for example, stockbroking. Even where the corporate status is not particularly desired, it may become necessary when the numbers in a partnership approach the upper limit allowed by law (that is, 10 in a banking firm and 20 in other cases).

Although companies limited by guarantee and unlimited companies both fulfil useful functions, the vast majority of all companies registered are limited by shares. The expression limited company is usually assumed to mean a company limited by shares unless the contrary is indicated.

NAME OF THE COMPANY

Although a company when incorporated is given a number, which is used for the purpose of registering and inspecting documents relating to that company, for all other practical and legal purposes it is identified by its name. This name must, therefore, be distinctive and it must be impossible for two companies to be registered with the same name or with names that are so similar that they are likely to lead to confusion. The name may be personal, impersonal, or a combination of both, for example, (1) J. Smith, Ltd.; (2) Toffee-Apples, Ltd.; (3) J. Smith (Toffee-apples), Ltd.

If the company is to acquire a business previously carried on by a trader in his own or even some other name, it will generally be desired to retain this in the name of the company. Unfortunately, there are now so many companies on the register that unless the name desired is very unusual it is most unlikely to be available for registration.

Thus, if J. Smith, who has traded in his own name for many years as a vendor of toffee-apples, decides to convert his business into a limited company, it is almost certain that the names J. Smith or J. Smith & Co. will not be available. By adding a geographical or descriptive word to the name, making it J. Smith (Much Binding), Ltd., or J. Smith (Toffee-apples), Ltd., it is possible that it will be admitted to the register.

The full and correct name of the company, as registered, must be displayed outside every place at which it carries on business, must be engraved on its seal and appear on all business letters, invoices and other documents. The word Limited (which can, however, be abbreviated to Ld. or, more usually, Ltd.) must always appear as the last word of the name, unless the Board of Trade has assented to the omission of the word from the name of the company. This assent is given only where an association has been, or is about to be, formed as a limited company for promoting commerce, art, science, religion, charity or any other useful object and the payment of any dividend to the members of the company is prohibited.

No company can be registered by a name which, in the opinion of the Board of Trade, is undesirable. This wide power is used to prevent the registration, except in suitable cases, of companies with names that include such words as Royal, Imperial, Chartered and Co-operative.

CONSTITUTION

The Constitution of a company is set out in two important documents, known as the Memorandum and Articles of Association.

The *Memorandum* of Association defines the purpose for which the company is incorporated and controls its dealings, as a legal entity, with the world at large. The *Articles* of Association, on the other hand, can be regarded as the internal regulations or bye-laws of the company and deal principally with questions of management and control.

The original copies of the Memorandum and Articles must be "subscribed" by at least two persons if it is to be a private company or by at least seven persons if it is to be a public company. The "subscribers" sign their names at the end of each document; in addition, in signing the Memorandum they express their willingness to take up at least one share each.

The signing of the Memorandum and Articles in this way constitutes a contract between the individual subscribers and the company (when it is incorporated) to take and pay for the number of shares for which each has signed. If all the shares in the company are taken up by other shareholders, the subscribers are released from their liability to the company. It is often found that the subscribers are not people who are really interested in the formation of the company, but are, say, clerks in the office of the solicitor who is engaged upon the registration of the company.

THE MEMORANDUM OF ASSOCIATION

The Memorandum of Association of a company limited by shares contains five clauses, as follows:

(1) The name of the company (of which Limited must be the last word).

(2) A statement that the registered office of the company is to be situate in England (or in Scotland, as the case may be). The actual address of the registered office is not stated; the purpose of this clause is merely to fix the domicile of the company. Within the country fixed for its domicile, its registered office can be moved freely from one place to another.

(3) A statement of the objects with which the company is established. Most companies are formed to carry on a business of one sort or another. The company must take power in its Memorandum to carry on a business of the nature intended and, as it is not always possible to foresee the way in which the business will ultimately develop, wide powers are usually taken to carry on many other kinds of commercial enterprise. Any action which is not covered by the objects set out in this clause of the Memorandum is said to be *ultra vires* the company (that is, outside its powers). Thus, although a company is a legal person, it differs from an individual person in one fundamental way. An individual person can start a new business

or do anything he chooses that is not actually illegal, whereas a company can do only those things which it was formed to do, as set out in its Memorandum. This doctrine of *ultra vires*, as it is called, may extend to such important matters as the power to borrow money, to invest in shares or other securities and so on. All these matters are, therefore, normally set out as objects in a series of sub-clauses which together constitute the "objects clause."

(4) A statement that the liability of the members is limited. (Without this clause the company would be an unlimited company.)

(5) The amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount. In view of the ease with which a company's authorized share capital can be increased from time to time (on payment of the appropriate duty), many companies are formed with a small authorized capital, which is subsequently increased. The capital may be divided into two or more classes of shares (say, Preference and Ordinary), but it is not essential that the rights of the different classes should be set out in the Memorandum.

These five clauses are followed by these words, which are sometimes referred to as the "association clause":

"We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association and we respectively agree to take the number of shares in the capital of the company set opposite our respective names."

ALTERATION OF THE MEMORANDUM

A company may, by special resolution, alter the provisions of its Memorandum with respect to the objects of the company, so far as may be required to enable it:

(1) to carry on its business more economically or more efficiently; or
(2) to attain its main purpose by new or improved means; or
(3) to enlarge or change the local area of its operation; or
(4) to carry on some business which under existing circumstances may conveniently or advantageously be combined with the business of the company; or
(5) to restrict or abandon any of the objects specified in the Memorandum; or
(6) to sell or dispose of the whole or any part of the undertaking of the company; or
(7) to amalgamate with any other company or body of persons.

The power to make these alterations by the simple process of passing a special resolution of the members of the company is introduced into company law by the Companies Act, 1948, S.5. Previously it was necessary to obtain the sanction of the Court to such changes. To protect the interests of minorities, however, power is given to the holders of not less than fifteen per cent in nominal value of the company's issued share capital or of any class thereof (or of debenture holders where the terms of issue give them such power) to apply to the Court to have the proposed alteration set aside.

To change the name of the company requires a special resolution of the members and the approval of the Board of Trade.

The domicile of the company can never be changed.

Alterations in the provisions of the Memorandum affecting share capital can normally be made by the company in general meeting; these are considered later in this chapter.

When an alteration is made in the Memorandum of a company, every copy of the Memorandum issued after the date of the alteration must embody the amendment.

THE ARTICLES OF ASSOCIATION

A company's Articles must be printed and divided into paragraphs numbered consecutively. Like the Memorandum, they must be stamped as though they were a deed (this applies only to the original documents which are filed at the Companies Registration Office; additional copies do not have to be separately stamped). They must be signed by each subscriber of the Memorandum.

The Articles normally contain regulations for dealing with the following matters:

Share Capital and Variation of Rights.

Lien, Calls on Shares, Transfer, Transmission and Forfeiture of Shares, Conversion of Shares into Stock and Alteration of Capital.

General Meetings of the Company and Votes of Members.

Directors, including their Powers and Duties, Remuneration, Disqualification, Rotation and Proceedings at their Meetings.

Appointment and Remuneration of Managing Director.

Secretary and Seal.

Accounts, Dividends and Reserves, Capitalization of Profits, and Audit.

In general, the Articles can lay down any regulation which does not conflict with the provisions of the Act or with the company's own Memorandum (which in that respect takes precedence over the Articles). They can have the effect of strengthening the provisions of the Act but cannot weaken them except where the Act provides for such a course.

For example, an Article that purported to make unnecessary an audit of the company's accounts would be invalid as every company is obliged to have its accounts audited before they are submitted to the members. On the other hand, an Article which extended the powers and duties of the auditors (for example, by requiring them to conduct a share transfer audit, which is not regarded as falling within the normal routine of the annual audit) would be legal and would have to be acted upon.

Subject to the provisions of the Act and to any conditions in its Memorandum, the Articles may be altered or added to by special resolution.

TABLE A

The first Schedule to the Companies Act, 1948, contains a model set of Articles which can be adopted in whole or in part by any company. This reduces considerably the length of the document which every company would otherwise have to have printed as its own Articles.

A company which was incorporated before July 1, 1948, and which adopted Table A either wholly or in part, will continue to be governed by the form of Table A then in force unless it has taken steps to adopt the new one. This is equivalent to altering the company's existing Articles and, therefore, requires a special resolution.

The new form of Table A differs from its predecessors in that it is divided into two parts. Part I includes a full set of regulations suitable for a public company; Part II cancels two of these and adds others which are necessary (see below) if a private company is required. Previously it was always necessary for a private company to file Articles of its own, although many provisions of Table A could be adopted. It is now possible, by adopting both parts of the new Table A, to register a private company without Articles of its own.

PUBLIC AND PRIVATE COMPANIES

The expression "public company" is not found in the Companies Acts, but it is freely used to signify any company which is not a private company.

A private company is one which, by its Articles:

(1) restricts the right to transfer its shares;

(2) limits the number of its members to fifty (not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company); and

(3) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Joint holders of shares (such as executors) are treated as a single member for the purpose of the above limit of membership. The chief advantage obtained by registering a private as distinct from a public company is that it may have as few as two members; in the case of a public company, which starts off with seven subscribers, the number of members must never fall below that figure. Private companies are, therefore, much used for the purpose of taking over the business of sole traders and small partnerships.

Although the expression "one-man company" is often used, there must always be at least two shareholders in even the smallest private company. If a company is formed to take over a small trader's business it is therefore essential that at least one share should be held by someone other than the principal shareholder; this person may, of course, be his wife, some near relation or even a nominee who agrees to hold the share on terms that he will transfer it to some other person whenever he is called upon to do so.

Private companies also enjoy the following advantages as compared with public companies:

(1) They can commence business immediately after incorporation without completing the further formalities that are necessary in the case of a public company.

(2) They are not required to file a statement in lieu of prospectus.

(3) They are not required to file a Statutory Report.

EXEMPT PRIVATE COMPANIES

Before the Companies Act, 1948, came into force all private companies were exempt from filing with the Registrar an annual Balance Sheet. This exemption is now enjoyed only by a restricted class of private company which is known for that reason as an "exempt private company." All other companies, including those private companies which do not qualify to be exempt private companies, must now file their annual accounts, which are thus available for inspection by any interested person.

An exempt private company is one which satisfies the stringent regulations laid down in the 7th Schedule to the Act in regard to persons interested in its shares and debentures. The basic conditions to qualify for exemption are:

(1) that no body corporate is the holder of any of the shares or debentures; and

(2) that no person other than the holder has any interest in any of the shares or debentures.

The first condition is intended to remedy the state of affairs previously existing under which a public company of the holding-company type could hold all or virtually all the shares in a subsidiary company which was registered as a private company and therefore did not have to file its accounts. A substantial part of the business of the group could be carried on by the subsidiary company (or there might be several such subsidiaries), but the only accounts available for inspection would be those of the holding company itself; now all the accounts must be filed.

If, however, the holding company is itself an exempt private company, then the exemption extends to its subsidiary or subsidiaries, provided the total number of members of all the companies concerned, exclusive of employees and ex-employees, does not exceed fifty.

The second condition is intended to overcome some of the dangers of the "nominee system," under which the persons who really control a company by owning the majority of its shares cloak their identity behind the names of nominees who hold the shares in trust for them. Companies in which such nominee holdings exist now have to file their annual accounts as though they were public companies; as most private companies do not wish to make their accounts public (the public including, amongst others, their competitors), this provision will, no doubt, discourage the holding of shares by nominees. Where public companies are concerned, however, the accounts always have to be filed, whether the conditions in the 7th Schedule are complied with or not.

There are many exemptions also from the second condition, to cover the holding of shares by executors, trustees under wills and settlements and for normal dealings of a business nature.

Exempt private companies also enjoy certain exemptions from the provisions of the Act in regard to the appointment of auditors.

COMPANY FORMATION

The following documents have to be submitted to the Registrar before a new company can be incorporated:

(1) A print of the Memorandum and Articles, each signed by the

requisite number of subscribers (seven for a public company, two for a private company). Before having this printed it is usual to submit the name of the proposed company to the Registrar for approval.

(2) A statutory declaration by either (*a*) a solicitor engaged in the formation of the company, or (*b*) a person named in the Articles as a director or secretary of the company, that all the requirements of the Act in respect of registration and of matters precedent and incidental thereto have been complied with. Except where a solicitor is engaged in the formation of the company it is therefore necessary that at least one of the persons who are to act as directors or secretary of the company should be actually appointed by the Articles.

(3) A statement of the nominal capital of the company. Although this amount will have been stated already in the Memorandum it is necessary to file a separate statement so that the appropriate amount of capital duty can be assessed; the payment of the duty is evidenced by stamps impressed on this form.

(4) If the company is a public one, a list of the persons who have consented to act as directors and, in the case of a director appointed by the Articles, his written consent to act as such.

In addition, the following documents have to be filed by all companies within a short time following their registration and in practice they are often submitted with the original application:

(1) A notice of the situation of the registered office of the company.

(2) A list of the directors of the company.

FEES AND STAMP DUTIES

The following fees are payable on the occasion of the incorporation of a company limited by shares:

(1) For registering the Memorandum:

Where the nominal capital does not exceed £5,000	£1 for each £1,000 or part of £1,000, with a minimum of £2.
Where the nominal capital exceeds £5,000:	
On the first £5,000	£5.
On the next £95,000	5s. for every £1,000 or part of £1,000.
On the remainder	1s. for every £1,000 or part of £1,000.

The total of the fees payable under these provisions, whether on the original formation of the company or on a subsequent increase of capital, is not to exceed £50, which is the fee applicable to a company registered with a capital of £525,000.

(2) For registering the Articles and any other document required by the Act to be registered: 5s. each.

(special fees are, however, payable in respect of the registration of a charge on the company's assets).

The foregoing fees are payable to the Board of Trade (Companies Registration Department) and are evidenced by impressed fee stamps on the documents concerned. They must not be confused with the inland revenue stamp duties, which are also payable as follows:

(1) Capital duty at the rate of 10s. per £100 on the original capital of the company or any subsequent increase in its nominal capital.

(2) Deed stamps of 10s. each on the Memorandum and Articles respectively.

(3) If the company is being formed to take over an existing business and, in particular, where shares are to be allotted to the vendor in full or part payment therefor, the contract for sale is normally subject to a stamp duty of £2 per £100 of the purchase consideration, but this may be subject to some exemptions and reliefs.

CERTIFICATE OF INCORPORATION

When the appropriate papers have been lodged with the Registrar and approved by him and the necessary fees, as set out above, have been paid, the Registrar issues a Certificate of Incorporation, which certifies that the company is incorporated and that (unless it is to be an unlimited company) it is limited.

This certificate is conclusive evidence that all the requirements of the Act in respect of registration and of matters precedent and incidental thereto have been complied with and that the association is a company authorized to be registered and duly registered under the Act.

The certificate gives the company a number which is the number of its file in the registry. This number has to be quoted on all documents which subsequently have to be filed.

The Certificate of Incorporation is usually framed and exhibited in a public place at the registered office of the company. It must be carefully preserved, as it may be necessary to produce it on certain occasions as proof that the company has, in fact, been incorporated (it does not, however, prove that the company is still in existence).

COMMENCEMENT OF BUSINESS

A private company can commence business (or take over an existing business) and exercise any borrowing powers (for example, by issuing debentures or incurring a bank overdraft) it may possess immediately after incorporation.

A public company, on the other hand, cannot commence business or exercise borrowing powers until the Registrar has issued a certificate that it is entitled to commence business. Before this is issued the company has to satisfy the Registrar that the conditions laid down in Section 109 have been fulfilled. These conditions are intended to ensure that the directors have taken up their qualification shares, if any, and that where money for shares or debentures is to be obtained from the public, the minimum amount required to carry on the business of the company has been effectively subscribed.

When shares or debentures have been issued to the public in conjunction with an announcement that permission for such securities to be

dealt in on a Stock Exchange will be sought, the application for the official certificate to commence business must contain a statement that there is no liability to return to applicants money received in respect of such offer.

SHARE CAPITAL—DEFINITIONS

Nominal (or *authorized*) capital is the total amount of capital which a company is, for the time being, authorized by its Memorandum to issue, and upon which capital duty has been paid.

Issued capital is the nominal (but not necessarily the paid-up) value of the capital actually issued to shareholders. This includes shares issued for a consideration other than cash (for example, credited as fully paid as part of the consideration for the acquisition of a business) as well as those actually applied for and allotted for a cash payment.

Paid-up capital is the total amount paid in cash (or credited as paid in the case of shares issued for a consideration other than cash) in respect of a company's issued capital.

Calls in arrear are calls or instalments that have become due on shares but have not yet been paid to the company.

Called-up capital is the paid-up capital plus any calls in arrear (or, more correctly, paid-up capital is the called-up capital less calls in arrear).

Uncalled capital is that part of the issued capital that has not yet been called up.

Unissued capital is that part of the nominal capital that has not yet been issued.

Example

X, Ltd., was incorporated in January with an authorized capital of £100,000 in shares of £1 each on which capital duty of £500 was paid, in addition to the appropriate company registration fees. In February it issued 20,000 shares, credited as fully paid, to X as part of the consideration for the acquisition of his business. It has also allotted 50,000 shares to various shareholders upon which calls amounting in all to 15s. a share have so far been made. Calls of 5s. a share on 12,000 shares have not yet been received.

The *nominal capital* is £100,000 (100,000 shares of £1 each).

The *issued capital* is 70,000 shares of £1 each—£70,000.

The *called-up capital* is £57,500 (20,000 at £1, plus 50,000 at 15s.).

Calls in arrear amount to £3,000.

The *paid-up capital* is £54,500.

The *uncalled capital* is £12,500. (The significance of this amount is that it could be called up, if necessary, to meet the claims of the company's creditors.)

The *unissued capital* is 30,000 shares of £1 each—£30,000.

CLASSES OF SHARES

Although the authorized capital of a company as laid down in its Memorandum has to be divided into shares of a fixed amount, this does not mean that all the shares must be of the same fixed amount or that

they must be all of one class. Shares of different classes can be created and even within the same class they can be of different nominal value (for example, Ordinary shares of £1 each and Ordinary shares of 1s. each), or can be issued on terms specifying that the amount called up is different on some shares from the amount called on others of the same class.

The rights and liabilities attaching to the various classes of shares are laid down either when the company is formed, by being set out in the Memorandum or Articles, or at the time of issue. Shares of the following types are commonly encountered:

Preference shares, which usually enjoy a preferential right to receive dividends as compared with shares of a lower class. The preference may also extend to a right to receive repayment, in the event of liquidation, in advance of other classes.

If the Preference shares are entitled to a preferential dividend at a fixed rate, this is usually incorporated in their title (for example, 6 per cent Preference shares would indicate that the holders are entitled to a dividend at the rate of 6 per cent per annum, less tax, before any dividend is paid to the holders of Ordinary or other shares).

Unless the terms of issue give specifically a right to preferential repayment in liquidation, Preference shares rank equally with others for such repayment (that is, they do not enjoy any preference). The terms of issue nearly always give this right, however.

There may be more than one series of Preference shares, these then being known as 1st Preference shares, 2nd Preference shares, etc., or as A Preference shares, B Preference shares, and so on. In such cases the 1st (or A) Preference shares normally enjoy absolute priority for dividend (and, if so provided, for repayment of capital) over all other classes of shares; 2nd (or B) Preference shares enjoy a preference which is subject only to the prior rights of the 1st (or A) Preference shares, and so on.

Cumulative Preference shares carry the right to a fixed preferential dividend, with the proviso that where the profits are insufficient for this dividend to be paid in any year, it is carried forward until such time as profits are available. Where the fixed dividend has not been paid up to date it is said to be in arrears, and a purchaser of such shares will normally acquire the right to receive these arrears, if and when they are paid, in addition to the current dividend.

Participating Preference shares are shares which enjoy the right to some additional dividend, over and above the fixed preferential dividend, if circumstances permit. This participation may take many different forms and it is commonly limited to a maximum rate in any one year. For example, 6 per cent Participating Preference shares might be entitled to:

(1) a fixed 6 per cent dividend in priority to other classes of shares;
(2) an additional 1 per cent (up to a maximum addition of 4 per cent, making a total of 10 per cent for the year) for every 5 per cent paid on the Ordinary shares for the year in question.

It must not be inferred that all 6 per cent Participating Preference shares enjoy exactly the same rights, however; the foregoing is merely one example out of a great number of possibilities.

Participating Preference shares may be cumulative or non-cumulative, according to the term of issue. Only the fixed portion of the dividend is cumulative in such cases.

Redeemable Preference shares are shares issued on terms specifying that they are to be, or at the option of the company may be, redeemed on some future date.

The issue, and in particular the redemption, of such shares is subject to the strict conditions laid down in the Act (S.58). These shares provide an exception to the general rule that a company's capital is normally subscribed once and for all and can only be returned to the shareholders in the event of liquidation or in certain special circumstances under the authority of the Court.

Ordinary shares are those to which no special rights or restrictions are attached. While they rank after the Preference shares, if any, for dividends (and, usually, for repayment of capital), there is normally no limit upon the rate of dividend which may be declared on such shares if the profits justify it.

Deferred shares are sometimes issued, ranking after the Ordinary shares. Such shares are frequently issued to the former proprietor of a business which is acquired by the company, and are then sometimes known as *Founders* shares.

The rights and privileges attaching to the Ordinary and Deferred shares respectively have to be outlined carefully in the terms of issue and they may have the effect of restricting the dividend on the Ordinary shares to a maximum rate in any one year. Alternatively, the total amount available for dividend may be divisible between the Ordinary and Deferred shares in a certain proportion (for example, one-third to the holders of Ordinary shares and two-thirds to the holders of Deferred shares, with Ordinary shares enjoying a preferential right to repayment in the event of liquidation).

A similar result can be achieved in a different way by creating two classes of Ordinary shares (for example, A Ordinary shares and B Ordinary shares).

The shares which enjoy the right to receive the surplus profits of a company, either as an annual dividend which is not limited in amount or, ultimately, as a return of capital (for it must be remembered that profits are not always paid out in dividends but may be ploughed back into the business) are often referred to as *equity* shares.

From the point of view of an investor, such shares are of a more speculative nature than fixed dividend shares. If large profits are made the holders of equity shares may receive a very large return on their investment; in a slump, however, they will be the first to suffer and will receive no dividend at all until the prior claims have been met.

DISTINCTIVE NUMBERS

When shares are issued (allotted) by a company, they have to be marked with distinctive numbers. This is necessary because certain rights or obligations may attach to some of the shares as distinct from others (for example, the Committee of the Stock Exchange may grant permission

to deal in certain shares within a limited range of numbers only). Should the company go into liquidation before certain shares have become fully paid-up, liability may attach to former holders as well as to the present holders of such shares; each share must therefore be numbered to distinguish it from others in the same class.

Once the shares have become fully paid, and provided all the issued shares of a particular class rank *pari passu* (equally) for all purposes, the distinctive numbers cease to fulfil any useful purpose. Section 74 of the 1948 Act makes it possible, in such circumstances, for the distinctive numbers of fully paid shares to be dispensed with.

STOCK

When a company has a share capital, one share is the smallest unit in which capital can be held. Once shares have become fully paid, however, they can be converted into "stock" which, subject to the terms of issue, can be divided or transferred in any amount. Stock is always referred to by its nominal value (for example, a shareholder may hold 100 Ordinary shares of £1 each in a company; if those shares are converted into stock he will then hold £100 Ordinary stock in the company).

However, to simplify the work of registering in the company's books transfers of stock from one stockholder to another, the terms of issue frequently provide that it is to be transferable only in multiples of a certain amount (say, 5s.). This amount is then known as a "stock unit" and the holder of £100 Ordinary Stock might alternatively be described as holding 400 5s. stock units.

Stock is always brought into being by a conversion of fully paid shares; it cannot be issued as stock in the first instance. Until 1948 it was not possible to dispense with the distinctive number of shares, even after they had become fully paid; stock, on the other hand, is never numbered in that way (obviously a share can be given a number, but there is no such thing as "a stock"). Many companies, therefore, converted their fully paid share capital into stock merely in order to eliminate the heavy work involved in registering the distinctive numbers of shares.

PROSPECTUSES

When a company proposes to raise either its original capital or, at a later date, additional capital by inviting the public in general to subscribe for a certain number of its shares, it does so by issuing a Prospectus. The main purpose of the prospectus is to give such details of the company's constitution, management, history and prospects, together with particulars of the shares for which application is being invited, as will encourage investors to apply.

The earlier history of the limited company system was marked by the issue of many prospectuses which, if not actually fraudulent, so misrepresented the prospects of the company, or failed to disclose material particulars concerning it, that many losses were suffered by the investing public. Successive Companies Acts have, therefore, laid down stronger and yet stronger rules governing the issue of prospectuses, so that this is now one of the most closely controlled features of company law.

The "matters to be specified in Prospectus and Reports to be set out therein" are contained in the 4th Schedule to the 1948 Act. The more important provisions can be summarized as follows:

(1) Particulars of the directors or proposed directors, including provisions for their remuneration and share qualification, if any.

(2) Time of opening of the subscription lists and particulars of the shares (or debentures) offered for subscription and of the rights attaching to the different classes of share capital, whether actually being issued or not.

(3) The minimum amount which, in the opinion of the directors, must be raised by the issue to cover the purchase price of property (where the issue is being made for that purpose), the expenses of the issue (including the preliminary or formation expenses of the company) and the necessary working capital to enable the company to carry on business. This amount is known as the Minimum Subscription.

(4) Particulars of any option which any person has or is to be given over unissued shares in the company.

(5) Contracts for the purchase of property which is to be paid for out of the proceeds of the issue, other than contracts entered into in the ordinary course of business, specifying the amount, if any, payable for goodwill.

(6) Particulars of the material contracts entered into during the period of two years before the date of issue of the prospectus.

(7) Amount or estimate of the preliminary expenses, issue expenses and underwriting commissions, if any.

(8) Names and addresses of the auditors, if they have been appointed.

(9) A report on the profits (or losses) of the company for the five financial years immediately preceding the issue of the prospectus (or from the commencement of business, if the company has not been trading for five years), on the dividends paid on the various classes of share capital during the same period, and on the assets and liabilities of the company at the end of it. If there are subsidiary companies the figures given have to relate to the whole group. This report is given by the company's auditors.

(10) If the proceeds, or any part of the proceeds of the issue, are to be applied directly or indirectly in the purchase of any business, a report on the profits and assets of that business, similar to the foregoing. This report is given by accountants named in the prospectus, who may be (but are not necessarily) the company's auditors. A similar report has to be given if, instead of purchasing a business outright, shares in another company are to be acquired and as a result that company will become a subsidiary of the one which is issuing the prospectus.

A prospectus is normally "issued" by newspaper advertisement and by the distribution of separate printed copies to the friends and customers of the persons who are interested in the issue. Before this is done, however, or at the latest on the same day, a copy must be delivered to the Registrar of Companies for registration. This copy has to be signed by all the directors and be accompanied by the written consent to its issue

of every "expert" (that is, engineer, valuer, accountant or other person whose profession gives authority to a statement made by him) who has made a statement or report for inclusion in the prospectus.

OFFERS FOR SALE

Where a company allots or agrees to allot any shares in or debentures of the company with a view to all or any of those shares or debentures being offered for sale to the public, any document by which the offer for sale to the public is made is to be deemed for all purposes to be a prospectus issued by the company. The offer for sale is usually made by an Issuing House, an institution specializing in the financing of limited companies.

The price at which the shares or debentures are offered to the public will naturally be in excess of the price at which they were obtained from the company. Out of the difference, which is a profit to the issuing house, the latter will have to meet its own expenses in connexion with the issue; in addition, it may sometimes agree to bear the formation expenses.

STATEMENT IN LIEU OF PROSPECTUS

If shares or debentures are to be offered to the public, either a prospectus or an offer for sale must be prepared and filed. A public company, however, may wish to issue shares or debentures privately; before it does so, it must file with the Registrar a Statement in lieu of Prospectus in the form set out in the 5th Schedule to the Act. This contains practically the same information, including reports on profits and assets, as would be given in a proper prospectus.

The general effect of all these provisions relating to prospectuses, offers for sale and statements in lieu of prospectuses is that a great deal of information regarding the financial position of a public company has to be made available to the public (including the Press) before it can issue any shares, either publicly or privately. These provisions apply only to public companies, however; the issue of shares by private companies is not subject to the same restrictions.

APPLICATION AND ALLOTMENT

Shares in companies are obtained either by transfer from an existing member or directly from the company in one of the following ways:

(1) By the act of signing the Memorandum, which constitutes a contract with the company to take the number of shares set against the subscriber's name.

(2) Under a contract for the sale of property to the company or for rendering services to it, in which the consideration to be received from the company consists wholly or partly of an allotment of shares in it.

(3) Under the procedure of application and allotment, which is an application of the legal principle of offer and acceptance.

Where a public issue of shares is concerned the third of these is the appropriate method.

It might at first be thought that the prospectus, in effect, offers shares for subscription and that acceptance of that offer by an intending share-

holder would complete the contract. Such a state of affairs would be impossible, however, as the company might very often find itself bound by contracts to allot shares in excess of its authorized capital. The prospectus is, therefore, worded in such a way that it is not in itself an offer; it invites offers to take shares on the terms set out in the prospectus. The application form is either printed as part of the prospectus, in the case of a newspaper advertisement, or circulated with the prospectus as a separate document in other cases.

If the issue is oversubscribed (that is, applications are received for a greater number of shares than it is proposed to issue) it will be necessary to scale down the applications. The application form is therefore worded so that the applicant offers to take a certain number of shares (this number being inserted by him) or such smaller number as the directors may allot to him. At least 5 per cent of the nominal value of each share must be paid on application (S.47).

The acceptance of the offer is signified by sending to the applicant a Letter of Allotment. This states the number of shares allotted to him, shows the total amount payable on application and allotment in respect of those shares and, after deducting the amount already paid on application, the balance due to be paid in respect of the shares allotted. Where the number of shares allotted is substantially less than the number applied for there will generally be a balance due to the applicant, for which a cheque will be sent to him with the allotment letter.

In the case of a public offer of shares, it is illegal for the company to proceed to allotment unless the minimum subscription stated in the prospectus has been applied for and the sum payable on application for the amount so stated has been paid to and received by the company. Further, the company must not, in such cases, proceed to allotment until the beginning of the third day (excluding Saturdays, Sundays and Bank holidays) after that on which the prospectus was first published. This is a new feature of company law introduced by the 1948 Act and designed to prevent the investing public being "rushed" into a new issue without adequate time for consideration (and discussions in the financial Press) of the prospectus.

Under the general law of contract an offer can be withdrawn at any time before it has been accepted. This applies to an application for shares in a company. In the past many persons, known as "stags," have put in applications for shares immediately a prospectus has appeared, and then, finding that the issue has not been oversubscribed and that it was unlikely that they would be able to make the quick profit they had hoped for, they have withdrawn their applications and had their application money refunded.

This state of affairs undoubtedly facilitated speculation in new issues and has been remedied by Section 50 (5) of the 1948 Act, under which, save in certain exceptional circumstances, an application for shares made in pursuance of a prospectus issued generally (that is, a public issue) is not to be revocable until the expiration of the third day after the time of the opening of the subscription lists.

Revocation must not be confused with renunciation. It is usual for

the terms of issue to provide that an allottee of shares may *renounce* either the whole or part of his allotment in favour of some other person, who will then be registered by the company as the first holder of the shares. To make this possible, a Renunciation Form is usually printed on the reverse of the allotment letter. Most companies agree to issue on request, and on payment of a small fee, "split allotment letters" to meet the requirements of original allottees who wish to renounce (that is, transfer to someone else) part only of their total allotment.

Unless the whole of the issue price of the shares is payable on application, detachable slips are usually provided at the foot of the allotment letters to enable the allotment money, and any further instalments that may become due before the share certificates are issued, to be paid at any branch of the company's bankers.

Allotments are made by resolution of the Board of Directors and must be properly minuted as such. Where private companies are concerned it is usual to dispense with the formality of completing application and allotment letters, as intending shareholders will usually have agreed in advance how many shares they are to take in the company. The shares must, nevertheless, be allotted by the directors and a resolution in the following form will usually be appropriate:

"Resolved that the undermentioned shares be and are hereby allotted, the sum of ....per share having been received in payment in full therefor:

Name	*Number of Shares*	*Distinctive Nos. of Shares*	
		From	*To*

RETURN OF ALLOTMENTS

Not later than one month after the date of allotment of any shares in a company, a Return of Allotments must be sent to the Registrar giving the following information:

(1) The number and nominal amount of the shares in the allotment.
(2) The names, addresses and descriptions of the allottees.
(3) The amount, if any, paid or due and payable on each share.
(4) In the case of shares allotted as fully or partly paid up otherwise than in cash, a contract in writing constituting the title of the allottee to the allotment, together with any contract of sale, or for services or other consideration in respect of which that allotment was made, *such contracts being duly stamped*; and a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up, and the consideration for which they have been allotted.

The general rules of contract law do not require that every contract shall be in writing; where, therefore, a sole trader is transferring his business to a company which is formed for that purpose, it might be thought unnecessary to have a written contract for the sale of his assets (in exchange for shares) to the company. This will not in itself avoid any

stamp duty, however, for if there is no written contract under which the shares are allotted (for a consideration other than cash) it is necessary to fill up a form giving particulars of the transaction and to pay the same stamp duty as if the contract had been in writing.

If, however, the vendor sells his assets to the company for cash and then applies that cash, or part of it, in paying for shares in the company, neither the contract nor particulars in lieu of it have to be filed and the payment of *ad valorem* stamp duty is avoided. Where this course is followed, the main objects clause as set out in the Memorandum should not refer specifically to the acquisition of the vendor's business but should give the company power to carry on a business of that type.

If freehold or leasehold property is to be transferred to the company it will, of course, be necessary for a proper conveyance or assignment to be drawn up and this will attract stamp duty on the usual scale.

ISSUE AT A PREMIUM OR DISCOUNT

Shares are not necessarily issued at their nominal or par value. They may always be issued at a premium over that value, and in some circumstances, and subject to the stringent conditions imposed by the Act, they may be issued at a discount.

The conditions under which shares may be issued at a discount are laid down in Section 57 and are as follows:

(1) The issue must be authorized by resolution passed in general meeting of the company, and must be sanctioned by the Court.

(2) The resolution must specify the maximum rate of discount at which the shares are to be issued.

(3) Not less than one year must, at the date of the issue, have elapsed from the time the company was entitled to commence business.

(4) The shares must be issued within one month after the date on which the issue is sanctioned by the Court or within such extended time as the Court may allow.

REGISTER OF MEMBERS

Every company has to keep a Register of Members containing:

(1) Names and addresses of the members.

(2) Number of shares held by each member and their distinctive numbers (unless distinctive numbers have been dispensed with).

(3) Amount paid or agreed to be considered as paid on the shares of each member.

(4) Date on which any person (*a*) was entered as a member; or (*b*) ceased to be a member.

If there are more than fifty members, an index to the register must be kept unless the register itself is arranged in the form of an index (such as a loose-leaf book). It is not now necessary that the register should be kept at the registered office of the company—it can be kept at any other office of the company where the work of making it up is done, or at the office of some other person who has undertaken to keep it. (Public companies often arrange to have their share-transfer registration work done by an independent firm of accountants or secretaries who specialize in

this work, which is of a very technical nature.) If the register is not kept at the company's registered office, however, notice must be given to the Registrar of Companies of the address at which it is kept. That address must also be within the country in which the company is domiciled.

Except where a company has given notice by public advertisement that its register of members is to be closed (for periods not exceeding, in the whole, more than thirty days in the year), it must be open to inspection during business hours by any member of the company without charge and by any other person on payment of a fee not exceeding 1s.

This register, and the right of inspection attaching to it, must not be confused with the file kept by the Registrar of Companies.

SHARE CERTIFICATES

The ownership of shares in a company is evidenced by a Share Certificate given under the common seal of the company, showing the name of the member and the number of shares (and their distinctive numbers, if any) of which he is the registered (that is, entered in the company's register of members) holder. The appropriate share certificates must be issued within two months after the allotment of any shares or the registration of a transfer as the case may be.

SHARE TRANSFERS

The transfer of a holding of shares from one person to another is normally effected by the execution, and registration with the company, of a deed of transfer. This is usually in the following form:

> I/We (*name and address of transferor*)
> in consideration of the sum of (*the amount payable by the transferee, which is not necessarily the same as the amount receivable by the transferor—see below*) paid by (*name and address of transferee*) hereinafter called the said transferee,
> Do hereby bargain, sell, assign and transfer to the said transferee:
> (*number, distinctive numbers* (*where applicable*) *and description of the stock or shares*)
> of and in the undertaking called
> (*name of the company*)
> To hold unto the said Transferee(s) subject to the several conditions on which (*I/We*) hold the same; and (*I/We*) the said Transferee(s), do hereby agree to accept and take the said (*Stock/Shares*) subject to the conditions aforesaid.
> As witness our hands and seals the day of
> One thousand nine hundred and
>
> Signed, sealed and delivered by
> the above named (*transferor*)
> in the presence of
> Signature (*name of witness*)
> Address (*address of witness*)
> Occupation (*occupation of witness*)
>
> Signed, sealed and delivered by
> the above named (*transferee*)
> in the presence of
> Signature (*name of witness*)
> Address (*address of witness*)
> Occupation (*of witness*)

The husband or wife of one of the parties cannot act as a witness to the signature of either party. The deed must be properly stamped with an impressed stamp at the rate of £2 per £100 of the consideration set forth in the deed. When stocks or shares in public companies are transferred through the machinery of the Stock Exchange fortnightly settlement, there will often have been no direct contract between the transferor and transferee. In that case, the consideration entered in the deed, upon which stamp duty is payable, is the amount payable by the transferee, which is not necessarily the amount receivable by the transferor.

Shares may sometimes be transferred from one person to another in circumstances which do not constitute a sale; the consideration in the transfer deal is then usually expressed as a nominal sum (say, 5s.) whatever the real or nominal value of the shares may be.

If there is no change in the beneficial ownership (for example, on the appointment of a new trustee or trustees or on transfer to the beneficiaries when a trust comes to an end) such transfers carry a deed stamp of 10s. Transfers so stamped, however, should not be accepted by a company for registration unless the facts have been certified on the reverse of the transfer deed and the latter bears the rubber stamp of the Inland Revenue stamping office that the transfer has been accepted for the fixed duty.

If shares are given by one person to another there is a change in the beneficial ownership; stamp duty is then payable on the market value of the shares, which must be adjudicated (that is, assessed) by the Inland Revenue. Where shares in a private company (or a public company whose shares are not dealt in on a recognized Stock Exchange) are concerned, the company may be called upon to produce evidence of the value of the shares. This is not necessarily their nominal value but may be evidenced by the prices at which *bona fide* sales of the shares have recently been negotiated or by the financial position of the company as revealed in its latest Balance Sheet.

During the existence of Exchange Control regulations it is also necessary to complete the appropriate certificates regarding both transferor and transferee, which are endorsed on the back of the common form of transfer deed.

TRANSMISSION ON DEATH OF A MEMBER

The death of a shareholder does not affect the continued existence of a company and does not reduce the number of members. The shares held by the deceased vest in his personal representatives, that is, the executors of his will if he made a valid will, or the administrators of his estate in other cases, where letters of administration have to be taken out. The company cannot recognize this state of affairs, however, until either the probate of the will or the letters of administration have been presented to it for registration. Once this registration has been effected, the personal representatives have (subject to the company's Articles) a choice of two courses, namely:

(1) They can ask to be registered as the legal owners of the shares, which will enable them to receive dividends, attend meetings and

generally enjoy all the advantages appertaining to membership of the company. It will, however, make them personally liable for calls on the shares, if they are not fully paid.

(2) They can sign, as personal representatives of the deceased, a transfer of the shares into the names of the persons beneficially entitled to them (that is, the persons named as beneficiaries in the will, or their trustees if the shares are to be held in trust, or the persons entitled on intestacy if the deceased did not make a valid will). As a general rule, such a transfer does not have to bear the *ad valorem* duty, but there are exceptions and the deed must be marked by the stamping office.

It must be noted that shares in a company registered under the Companies Act, however small, cannot be transferred after the death of a member except upon production of probate or letters of administration. This is so even if the estate of the deceased member is not large enough to attract any liability for death duties.

RESERVE LIABILITY

By Section 60 of the Act a limited company is empowered to pass a special resolution under which a portion of its share capital which has not already been called up shall not be capable of being called up except in the event and for the purposes of the company being wound up. This amount, which can only be called up in the event of liquidation, is then known as Reserve Capital and must not be confused with a "capital reserve." The existence of reserve capital is intended as a protection for creditors of the company and is considered to have the effect of enhancing its credit.

Comparatively little use of this procedure has been made in the past, however, as shares carrying any uncalled liability (whether reserved or not) are not popular with investors.

INCREASE OF SHARE CAPITAL

If so authorized by its Articles, a company may increase its share capital by the simple process of passing an ordinary resolution of the members. A company which operates under Table A has the power to increase its capital by ordinary resolution. Where special Articles have been registered, however, it may be found that some other procedure is necessary (for example, a special resolution or separate resolutions of each class of shareholders where more than one class of shares have already been issued). The appropriate capital duty and registration fee must, of course, be paid.

REDUCTION OF SHARE CAPITAL

The provisions of the Act controlling the reduction of a company's issued capital are much more stringent than those dealing with increases and other alterations. The capital subscribed by shareholders (or agreed to be subscribed, where the shares are not yet fully paid) is, in effect, a fund out of which creditors are entitled to look for payment of their claims. It must not be possible, therefore, for the members themselves

to take any action which would reduce the fund to which creditors are entitled to look for protection.

Therefore, all schemes involving the reduction of issued capital require to be sanctioned by the Court and, where the proposed reduction involves either diminution of liability in respect of unpaid share capital or the repayment to any shareholder of any paid-up share capital, and in any other case if the Court so directs, either the creditors must individually assent to the scheme or they must be paid off or secured in accordance with the instructions of the Court.

Capital reduction schemes may be of the following types:

(1) To extinguish or reduce the liability on shares in respect of share capital not paid up.

Example

A company was formed many years ago with a nominal capital of £100,000 in £1 Ordinary shares, the whole of which were issued and called up to the extent of 10s. per share. The paid-up capital is, therefore, £50,000.

The company's business has become firmly established and there is no question of insolvency. With the consent of the creditors and the Court, the uncalled liability of 10s. per share can be cancelled and the issued capital of the company will become £50,000 in 100,000 Ordinary shares of 10s., each fully paid.

(2) To cancel paid-up share capital which is lost or unrepresented by available assets. Schemes of this nature are primarily a matter of accountancy and are considered in Chapter XII.

(3) To pay off any paid-up share capital which is in excess of the needs of the company.

Example

A company formed many years ago with a capital of £100,000 in £1 Ordinary shares, which were all issued and fully paid up, conducted its business through two branches. One of these branches has recently been sold and there is no intention of replacing it by another; the proceeds of sale amounting to over £50,000 are, therefore, lying idle in the company's bank account.

With the consent of the creditors and the Court, the company may return 10s. per share to its members, so that its issued capital will be £50,000 in 100,000 Ordinary shares of 10s., each fully paid.

Before the necessary consent of the Court can be obtained to any of these schemes the company must have power in its Articles to reduce its capital and must pass a special resolution of the members. As a condition of assenting to the scheme, the Court has power to direct that the words "and reduced" shall be added to the company's name; this power is now very rarely exercised, however. Before the reduction can take effect the order of the Court must be filed with the Registrar; it must then be published in such a way as the Court directs.

Although the day-to-day administration of a company is a matter for its directors and officers, the ultimate control of the company's destinies must remain in the hands of the members (shareholders), who are, in effect, the proprietors of the company. This control is exercised by the holding of meetings of the shareholders. Subject to the overriding provisions of the Act, the regulations regarding the calling and conduct of such meetings are laid down in the company's Articles.

Meetings of shareholders are known as general meetings, to distinguish them from meetings of the directors, which are board meetings. General meetings are either ordinary or extraordinary, of which the following are ordinary meetings:

(1) The Statutory Meeting, which is held by public companies only.

(2) The Annual General Meeting, which is held once a year by all companies.

All other meetings of shareholders are extraordinary.

STATUTORY MEETING AND REPORT

The purpose of the statutory meeting (which is not held by private companies) is to enable the shareholders who have invested money in a new concern (generally on the faith of a prospectus or offer for sale, offering shares in the company for subscription) to receive a report from the directors upon the amount raised by the issue of capital and similar matters which arise on the formation of a new company.

The statutory meeting must be held not less than one month nor more than three months from the date on which the company is entitled to commence business.

The statutory report has to state (S.130):

(1) The total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted.

(2) The total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid.

(3) An abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company.

(4) The names, addresses and descriptions of the directors, auditors, if any, managers, if any, and secretary of the company.

(5) The particulars of any contract the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

In so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and pay-

ments of the company on capital account, the statutory report must be certified by the company's auditors, if any. A copy of the report must be sent to every member of the company and to the Registrar not less than 14 days before the date of the statutory meeting.

ANNUAL MEETINGS

The main purpose of an annual meeting is to receive the directors' report and the audited accounts of the company. These are considered in detail in Chapter XIII. Other business ordinarily transacted includes the election or re-election of directors and the appointment of auditors.

The first annual meeting of a company must be held within 18 months of its incorporation; subject to this it need not hold an annual meeting in the year of its incorporation or the following year. Subsequently, not more than 15 months may elapse between the date of one annual general meeting of a company and that of the next; this is subject to the qualification that a meeting must be held once in every year.

Example

A company was incorporated on 5 November, 1948; the latest date on which its first annual general meeting may be held is, therefore, May 5, 1950. If, in fact, it holds its first annual meeting on December 20, 1949, then it must hold its next annual meeting at the latest on December 31, 1950; otherwise there will have been no annual meeting in the year 1950. If, however, the first annual meeting was held on January 20, 1950, then the next one can be held at any time up to April 20, 1951.

The responsibility for calling an annual meeting (and, for that matter, any other meeting of the shareholders) rests primarily with the directors of the company. If they do not call a meeting within the time limits set out above, however, then any member of the company may apply to the Board of Trade to call, or direct the calling of, a general meeting of the company.

EXTRAORDINARY MEETINGS

Since certain matters require to be authorized by a resolution of the members of a company (for example, an increase or reduction of capital) it must be possible to call a meeting of the members at any time during the year. Such a meeting, whatever its purpose, is an extraordinary general meeting, and it is normally called by the directors for a purpose such as has been indicated.

Circumstances may arise, however, in which a member or members of the company, other than its directors, consider that an extraordinary meeting should be called as soon as possible. In such a case, the holders of not less than one-tenth of the paid-up capital which carries voting rights have the right to "requisition" a meeting. The requisition must state the objects of the meeting and must be signed by the requisitionists and deposited at the registered office of the company. The directors must then proceed to call the meeting; if they do not do so within 21 days the requisitionists may call it themselves.

NOTICE OF MEETINGS

Members of a company are entitled to receive notice in writing of general meetings as follows:

(1) An annual general meeting or a meeting at which a special resolution is to be proposed—21 days.

(2) Any other general meeting of a limited company—14 days.

These periods may be extended but not reduced by the company's Articles. Circumstances may arise, however, in which it is necessary to call a meeting at short notice; such a meeting will be deemed to have been duly called if it is so agreed:

(1) in the case of a meeting called as the annual general meeting, by all the members entitled to attend and vote thereat; and

(2) in the case of any other meeting, by a majority of 95 per cent (in nominal value of shares held) of members having a right to attend and vote at the meeting.

RESOLUTIONS

Unless otherwise provided for in the Act or in a company's Articles, resolutions at general meetings are passed by a simple majority of the members present and voting (subject to the provisions regarding proxies and polls considered later). Such a resolution is known as an *ordinary* resolution. For certain purposes, however (these being purposes which are or are likely to be of considerable importance to the members of the company), it may be necessary to pass either an *extraordinary* or a *special* resolution.

Extraordinary and special resolutions are similar in the following respects:

(1) They must be passed by a majority of not less than three-fourths of the members who vote on the resolution.

(2) The notice of the meeting must specify that the resolution is to be proposed as an extraordinary or a special resolution, as the case may be.

(3) Within 15 days after the passing of the resolution a copy of it must be filed with the Registrar.

(4) A copy of the resolution must be embodied in or annexed to every copy of the company's Articles issued after the passing of the resolution.

They differ only in the length of the notice that must be given to the members, which is as follows:

(1) For an extraordinary resolution—such notice as is necessary to call a valid meeting of the company, which in the case of an extraordinary meeting is normally 14 days.

(2) For a special resolution—not less than 21 days.

A special resolution must not be confused with a *special notice resolution*, which is a resolution which a member of a company proposes to move at a forthcoming meeting. The Act gives members the right to propose resolutions on certain subjects (for example, to remove a director before the expiration of his term of office) only if they have given not less than 28 days' notice of their intention to the company; the company

then gives notice of the resolution to the members as a whole when it sends them the notice of the meeting.

A resolution (of any kind) which is passed at an adjourned meeting is treated for all purposes as having been passed on the date on which it was in fact passed, and therefore not on the date for which the meeting was originally called.

VOTING RIGHTS

The right to vote at general meetings of the company is one of the rights which normally attaches to a holding of shares. The normal method of voting is by show of hands, when every voter has one vote and one vote only. If a poll is demanded, however, each member will enjoy a number of votes as determined by his shareholding and the rights attaching to shares of that class.

Subject to any contrary provision in the Articles, each member has one vote in respect of each share (or, where shares have been converted into stock, each £10 of stock) held by him. The Articles frequently provide, however, that holders of Preference shares shall have no right to vote unless their dividend is in arrear.

APPOINTMENT OF PROXIES

A member who is unable or unwilling to attend a meeting may appoint a proxy to attend and vote for him. Unless the Articles otherwise provide, a proxy is not entitled to vote except on a poll; at a meeting of a private company, however, he has the same right to speak at the meeting as the member for whom he is acting. The person appointed proxy need not himself be a member of the company; the appointment is made by filling up and depositing with the company at least 48 hours before the meeting a form similar to the following:

> "......................................., Limited
> I/We.......................... of.........................., in the County of........................being a member/members of the above-named Company, hereby appoint....................... of......................., or failing him....................... of......................................, as my/our proxy to vote for me/us on my/our behalf at the (*annual or extraordinary, as the case may be*) general meeting of the Company to be held on the........... day of.....................19.., and at any adjournment thereof. Signed this...........day of........................19.."

An instrument in the above form enables the proxy to vote for or against a resolution, as he may decide after attending the meeting and listening to the arguments advanced for and against it. Where the absent shareholder has already decided in which direction his vote is to be cast, the following words can be added to the instrument:

> "This form is to be used $\frac{\text{in favour of}}{\text{against}}$ the resolution. Unless otherwise instructed the proxy will vote as he thinks fit."

Proxy forms may be sent out at the company's expense when it is

desired to ensure that all members, whether they are able to attend the meeting in person or not, shall have the opportunity of voting on an important resolution. The form must, however, be sent to all members entitled to vote on the resolution (and not, for example, merely to those who are thought likely to support the directors).

MINUTES OF MEETINGS

A minute is a record of the proceedings at a meeting and in particular of the resolutions proposed and of the results of the voting on such resolutions. Minutes must be kept of the proceedings at all general meetings of a company. Any such minute, if purporting to be signed by the chairman of the meeting at which the proceedings were had, or by the chairman of the next succeeding meeting, is evidence of the proceedings and, until the contrary is proved, the meeting is deemed to have been duly held and convened, and all proceedings had thereat to have been duly had and all appointments made at it to be valid (S.145).

Although the Act provides for the keeping of a minute book it is not necessary that this should take the form of a bound volume; a loose-leaf record will comply with the Act.

The book containing the minutes of general meetings is frequently known as the Shareholders' (or Members') Minute Book to distinguish it from the Directors' Minute Book. The Shareholders' Minute Book must be kept at the registered office of the company and be open to inspection during business hours by members of the company without charge. This right of inspection does not apply to the Directors' Minute Book; the two sets of minutes are therefore preferably kept separately.

FUNCTIONS OF DIRECTORS

The directors of a company are responsible for the management of its business. They are not trustees for the shareholders, but stand in a fiduciary relationship to them; that is to say, they have a duty to account to the shareholders for their dealings with the company's assets and must act always in the interest of the company as opposed to their own personal interests.

Although the directors are responsible for the management of the company, this does not mean that they necessarily devote the whole of their time to the conduct of its affairs. The day-to-day control of the company is usually entrusted to one of the directors, who is then known as the managing director; alternatively, a manager may be appointed who is not a director. Meetings of the directors at which such of their functions as require the passing of formal resolutions are carried out are known as board meetings.

Directors usually, but not necessarily, hold shares in the company; it is then necessary to distinguish between their rights and duties as directors and their rights as shareholders. This is so even if, as frequently occurs in small private companies, there are only two or three shareholders who are all directors of the company. A private company can legally have a sole director, but a public company must always have at least two directors; a larger number is, of course, usual.

APPOINTMENT OF DIRECTORS

Unless the first directors of a company are named in its Articles they are appointed by the signatories to the Memorandum. Subsequent appointments are made by the members in general meeting, subject to the regulations laid down in the Articles. These normally give the directors themselves the right to appoint new directors to fill vacancies arising from the death or retirement of existing directors, or to appoint additional directors, subject to the provisions of the Articles regarding the maximum number. New directors appointed in this way usually have to be re-elected by the members at the next annual general meeting; other directors of the company normally retire by rotation every three years and have to seek re-election.

It is not essential that a director should be an individual person; one company can be a director of another.

Except with the leave of the Court by which he was adjudged bankrupt, an undischarged bankrupt may not act as a director of, or directly or indirectly take part in the management of, any company. It is also provided that persons who have been convicted on indictment of any offence in connexion with the promotion, formation or management of a company may be debarred by an order of the Court from being appointed a director of a company, save with leave of the Court.

REMOVAL AND RETIREMENT OF DIRECTORS

Notwithstanding anything in the Articles or in any agreement between a director and the company, he may be removed from his office by an ordinary resolution of which special notice has been given.

The 1948 Act also contains new provisions designed to secure the retirement of directors at the age of seventy, but these provisions do not apply to private companies (except private companies which are subsidiaries of public companies) and in any case may be overruled by the provisions of the company's Articles. Where the provisions apply but in exceptional circumstances it is desired to appoint or continue in office as director a person who is over the age of seventy, this may be done in general meeting by resolution of which special notice has been given. The onus of disclosing his age to the company, so that these provisions can be applied, is placed upon the director.

Apart from the foregoing, a director can, of course, resign his office at any time, subject to the terms of any special agreement he may have entered into with the company.

SHARE QUALIFICATION

Unless the company's Articles so provide, a director need not hold any share qualification. Table A (1948) provides that a shareholding qualification may be fixed by the company in general meeting and until so fixed no qualification is required.

Public companies, and, more particularly, public companies which propose to offer shares to the public for subscription, usually fix a share qualification for directors. This is to show shareholders and intending shareholders that the directors have sufficient faith in the prospects of

the company to invest some of their own money. In such cases, no person must be named in any prospectus or statement in lieu of prospectus issued within the first year unless he has either already taken up his qualification shares or filed with the Registrar an undertaking in writing to take them up.

Apart from the foregoing provisions, every director of a company (public or private) who is required to hold a share qualification must obtain it within two months of his appointment or such other time as may be fixed by the Articles. If he fails to acquire his qualification within that period or if, after the expiration of that period, he ceases to hold it, he vacates his office, and if he continues to act as a director while unqualified he may become liable to a penalty not exceeding £5 a day.

REGISTER OF DIRECTORS

Every company is required to keep, at its registered office, a register of its directors and secretaries.

The register must contain the following particulars with regard to the directors:

(1) In the case of an individual:
- (*a*) his present Christian name and surname;
- (*b*) any former Christian name and surname;
- (*c*) his usual residential address;
- (*d*) his nationality;
- (*e*) his business occupation, if any, and particulars of any other directorships held by him;
- (*f*) the date of his birth, if the company is one whose directors are liable to retire under an age-limit rule.

(2) In the case of a corporation:
- (*a*) its corporate name;
- (*b*) its registered or principal office.

The register has to be open to inspection by any member of the company without charge and by any other person on payment of a fee not exceeding 1s.

Copies of the register of directors have to be filed with the Registrar within 14 days from the appointment of the first directors of the company and subsequently within 14 days from any change (for example, the resignation of an existing director of the company or the appointment of a new one).

In addition to the publicity secured by the keeping of the company's own register of directors and the filing of copies with the Registrar, it may be noted that all companies incorporated after November 22, 1916, are required to state the names of their directors in all "trade catalogues, trade circulars, showcards and business letters on or in which the company's name appears and which are to be issued or sent by the company to any person in any part of His Majesty's Dominions." Any former name or names of a director, and his nationality if not British, must also be stated; the Board of Trade has power, however, to exempt a company from the application of these provisions.

It is usually left for the directors themselves to fix the date of their meetings. Questions arising at any meeting are decided by a majority of votes. Each director, as such, has one vote; the chairman may exercise a casting vote in the case of an equality of votes.

There is no power to demand a poll at a meeting of directors because the shareholding of each director is, for this purpose, of no significance.

The Articles may fix a quorum (failing which the directors may fix it themselves) or minimum number of directors required to constitute a valid meeting. It may happen that through death or retirement, the number of directors acting may fall below this quorum; in that case, a meeting of the remaining directors may validly appoint additional directors or summon a general meeting of the company for the same purpose.

Minutes must be kept and are open to inspection by the directors themselves, but not by shareholders who are not directors, or by other persons.

If approved by the Articles, a resolution in writing signed by all the directors (or, preferably, all the directors who are entitled to receive notice of meetings, which excludes any who are temporarily absent from the United Kingdom) is as valid and effectual as if it had been passed at a meeting duly convened and held.

REMUNERATION OF DIRECTORS

The remuneration of the directors of a company is either fixed by the Articles or by the members in general meeting. The remuneration of the managing director as such is, however, normally fixed by the directors themselves, as is the salary of any other director who holds a full-time office in the company, such as that of sales manager.

It is no longer legal for a director's remuneration to be fixed "free of tax." The making of loans to directors is also prohibited under the Act of 1948, but this does not apply to exempt private companies or to loans made in the ordinary course of business by a company whose ordinary business includes the lending of money (for example, a bank).

Payments to a director as compensation for loss of office, either by the company itself or some other person or company, are legal provided they have been disclosed to and are approved by the members of the company.

Other matters affecting the foregoing are dealt with in Chapter XIII.

INTEREST OF DIRECTORS IN CONTRACTS

In the ordinary course of its business a company may have occasion to enter into contracts with many other companies and firms, in some of which one or more of its own directors may be interested. This is quite proper provided the director or directors concerned have revealed their interest in the matter to their co-directors.

A general notice may be given by a director to his co-directors to the effect that he is a member of a specified company or firm and is to be regarded as interested in any contract which may, after the date of the notice, be made with that company or firm. If a general notice covering

a particular contract has not been given, then any director who is interested in the contract must declare his interest at the first meeting at which it is considered.

Apart from disclosing his interest in the matter, a director who is interested in a proposed contract should not vote on any resolution concerning it or be taken into account in considering whether a quorum of directors is present for that purpose. This does not preclude him from voting as a shareholder at a general meeting of the company on a motion in which he is interested. Directors who are shareholders may therefore vote their own remuneration at a general meeting of the company. By Section 195 a register of directors' shareholdings must be kept.

DUTIES OF SECRETARY

Every company must appoint a secretary, who is an officer of the company. His principal duties are to make the various returns required by the Registrar of Companies, to carry out the instructions of the directors in regard to the calling of meetings of directors and members, and to keep minutes of those meetings. He is responsible for keeping the company's register of members and other statutory books, unless a registrar is specially appointed for that purpose.

The sole director of a company cannot also act as its secretary. Where there are two or more directors, however, one of them may act as secretary provided he does not attempt to act in both capacities at the same time.

The company's register of directors and secretaries must contain the following particulars with regard to the secretary:

(1) in the case of an individual, his present Christian name and surname, any former Christian name and surname, and his usual residential address; and

(2) in the case of a corporation, its corporate name and registered or principal office.

Where there are joint secretaries, the above particulars must be given in respect of each of them except that if all the partners in a firm are joint secretaries (which is the position where, say, a firm of accountants is appointed to act as secretaries to the company) the name and principal office of the firm only need be given. The particulars must also be given in the copy of the register of directors and secretaries which is filed with the Registrar of Companies, both initially or on any change occurring in the recorded particulars. In the case of the secretary, as distinct from the directors, however:

(1) it is not necessary to record any other business occupation or directorships that he may hold;

(2) the regulations which require the names of directors to be disclosed in business letters, etc., do not apply to the secretary.

The remuneration and terms of appointment of a secretary are fixed by the directors. The office is not necessarily a full-time one and professional firms are frequently appointed for the following reasons:

(1) In small private companies there is normally insufficient work to justify a full-time appointment.

(2) In large public companies the office demands a very high degree of professional knowledge and experience, coupled with facilities for dealing with a large volume of work (for example, the preparation of dividend warrants) at certain times.

REGISTERED OFFICE

Every company must have a registered office to which all communications and notices may be addressed. This does not mean that, in the ordinary course of business, every letter addressed to the company has to be sent to its registered office; the business may be carried on from various offices and branches which will each receive and deal with its own routine correspondence. But for legal purposes (for instance, the serving of a writ upon the company) there must be one address (and, at any given time, one only) at which communications properly delivered will be deemed to have been received by the company.

For this reason the address of the registered office must be open to inspection on the company's file at the appropriate Companies Registration Office. A new company must, therefore:

(1) acquire a registered office either as from the day on which it commences to carry on business or as from the 14th day after the date of its incorporation, whichever is the earlier, and

(2) give notice to the Registrar of Companies of that address within 14 days after the date of incorporation of the company.

The Memorandum of the company fixes its domicile by saying that "its registered office shall be situate in England" or "in Scotland" as the case may be. Within the limit thus fixed the registered office can be moved from time to time, but notice of any such change must be given to the Registrar of Companies within 14 days.

The various statutory books which a company must keep and which are available for inspection by the members (and, in some cases, by other persons) must be kept at the registered office of the company. As already stated, this does not apply to the register of members, however, if notice has been given of the intention to have it kept elsewhere.

DUTIES OF REGISTRAR

The power given to a company to keep its register of members at an address other than that of its registered office recognizes that many companies find it convenient to delegate their share-transfer work to a firm or company which has special experience in and facilities for carrying out such matters. A registrar so appointed is an officer of the company itself and must not be confused with the Registrar of Companies, who is an official of the Board of Trade.

If a company appoints its own registrar his principal duties will normally comprise:

(1) The keeping of all registers of shareholders (and, where appropriate, debenture holders).

(2) The registration of all transfers of shares (stock and debentures) and the preparation of the new certificates arising from such transfers.

(3) The preparation of dividend and interest warrants and the sending out of such warrants and other communications to shareholders and debenture holders.
(4) Dealing with new issues and other similar matters affecting the company's capital.
(5) Making the appropriate returns to the Registrar of Companies.

COMMON SEAL

The corporate status of a company makes it necessary to provide it with a "common seal," so that formal documents such as deeds and share certificates can be properly executed. The seal is normally a circular device containing the name of the company in embossed characters; it is inserted in a press so that it can be impressed upon the document which is to be executed.

The seal must be used only with the authority of the directors, in the manner laid down by the company's Articles. The fact that it has been properly affixed to a document in conformity with such authority is certified by the appropriate officers of the company in the following way:

"The common seal of..............................Limited was affixed hereto in the presence of:
............................Director.
............................Secretary."

The Articles usually provide, as in the example above, for the seal to be affixed in the presence of one director and the secretary. In such cases, if the secretary is a director of the company he must not act in both capacities. Table A provides that a second director may act in lieu of the secretary.

The seal is normally kept at the registered office of the company; it is incumbent upon the directors to make proper arrangements for its safe custody. Many companies keep a seal book or register in which a record is kept of all documents to which the seal has been applied; this may be useful as a precaution against the unauthorized use of the seal, but it is not a requirement of the Act.

The seal is officially adopted by the company at the first meeting of its directors; this is usually recorded by an impression of the seal in the margin of the Minute Book.

MAKING OF CONTRACTS

Subject to the powers conferred upon a company by its Memorandum, contracts entered into on its behalf by its directors, officers and employees are binding upon it. Where a deed is necessary (for instance, in granting or taking a conveyance of land) the contract is made in writing, under the common seal of the company. In other cases:

(1) A contract which, if made between private persons, would be by law required to be in writing, signed by the parties to be charged therewith, may be made on behalf of the company in writing, signed by any person acting under its authority, express or implied.
(2) A contract which, if made between private persons, would by law

be valid although made by parol only (that is, orally) and not reduced into writing, may be made by parol on behalf of the company by any person acting under its authority, express or implied.

When a contract in writing is entered into on behalf of a company the person signing should add the words "For and on behalf of........... Limited" above his signature and indicate the capacity (director, manager, secretary, etc.) in which he signs. Rubber stamps are normally used for this purpose.

In particular, bills of exchange (including cheques) should always be signed "for and on behalf of" the company, as otherwise the signer may find himself personally liable to meet the bill.

ANNUAL RETURN

The annual accounts of a company, and the auditors' report thereon, are "published" (in addition to being sent to members and other persons in compliance with the provisions of Section 158) by being annexed to its Annual Return to the Registrar of Companies; being placed on the company's file at the Registry, the return is available for inspection by any person who is interested. Exempt private companies, however, are exempt from this requirement and the publication of their accounts is thus limited to members, debenture holders and other persons (if any) who are entitled to receive notices of general meetings.

The annual return has to be made up once a year to a date 14 days after the date of the annual general meeting for that year, and must be completed and sent to the Registrar within 42 days after the date of that meeting. It must be signed by a director and by the secretary of the company.

The return is made on a form which can be obtained either from the Registrar or from a firm of law stationers.

Although the form of the returns prescribed by Section 124 and the 6th Schedule to the Act includes *inter alia* a complete list of:

(1) persons who are shareholders (or stock holders) at the date of the return, and

(2) persons who have ceased to be shareholders (or stock holders) since the date of the last return, or, in the case of the first return, since the incorporation of the company;

and gives particulars of the shares (or stock) either held by them at the date of the return, or transferred by them since the date of the last return, advantage may be taken of the provisions of Section 124 (1) (c), under which a complete return need be made only once in every three years, it being sufficient in the intervening years to give details of the *changes* in shareholdings (or holdings of stock) that have occurred since the date of the preceding return.

If the company is a private company (whether it is an exempt private company or not) a certificate must be given by a director and the secretary to the effect that "the company has not since the date of the last annual return (or in the case of the first return, since the date of incorporation of the company) issued any invitation to the public to subscribe for any shares or debentures of the company."

In addition, if the company claims to be an exempt private company (and thus exempt from the obligation to file its audited accounts) a certificate must also be given by a director and the secretary in these terms: "We certify that, to the best of our knowledge and belief, the conditions mentioned in subsection (2) of Section 129 of the Companies Act, 1948, are satisfied at the date of this return and have been satisfied at all times since.........."

The date to be entered in this certificate is the latest of the following:

(1) July 1, 1948 (when the Act came into force);

(2) the date of incorporation of the company;

(3) the date upon which it is shown to the Board of Trade that the conditions were satisfied.

It should be noted particularly that exemption cannot be claimed merely because the conditions have been satisfied throughout the period from one return to the next; if the company has not been an exempt private company throughout the whole of its life (or since July 1, 1948, if it was incorporated before that date), it cannot become one except as a result of an application to the Board of Trade under the provisions of Section 129 (1).

Other information to be provided in the annual return includes:

(1) Address of the registered office of the company.

(2) Situation of registers of members and debenture holders.

(3) Summary of share capital and debentures.

(4) Total indebtedness in respect of mortgages and charges.

(5) Particulars of directors and secretaries.

DEBENTURES AND CHARGES: BORROWING POWERS

Although the Courts have held that a trading company has an implied power to borrow money and to give charges on its assets as security for such loans, it is nearly always found that these powers are taken expressly in the Memorandum of the company. It is not unusual, however, for the Articles to restrict the rights of the directors in regard to the exercise of such powers. Clause 79 of the 1948 Table A provides as follows:

"The directors may exercise all the powers of the company to borrow money and to mortgage or charge its undertaking, property and uncalled capital, or any part thereof, and to issue debentures, debenture stock, and other securities whether outright or as security for any debt, liability or obligation of the company or of any third party;

Provided that the amount for the time being remaining undischarged of moneys borrowed or secured by the directors as aforesaid (apart from temporary loans obtained from the company's bankers in the ordinary course of business) shall not at any time, without the previous sanction of the company in general meeting, exceed the nominal amount of the share capital for the time being issued,.........."

Within the powers conferred by its Memorandum and Articles, a company may borrow money and give security for money so borrowed in any way that would be open to an individual. If no security is given, the lender will rank as an unsecured creditor; his position, in the event of the company failing, will be no better and no worse than that of a

trade creditor for goods supplied. Alternatively, security may be given in the form of a mortgage of a specific asset belonging to the company; if it owns its premises it can, for example, mortgage them to a building society or otherwise.

In addition to the foregoing, a company can give two forms of security for borrowed money which are not available to individuals:

(1) It can charge its uncalled capital.

(2) It can create a floating charge on all its assets for the time being.

DEBENTURES

The term debenture may be applied to a document (usually, but not necessarily, one of a series) issued by a company as an acknowledgment of its indebtedness to the holder of the debenture. Where the liability is unsecured, the instrument is termed a naked debenture; such documents are rarely encountered in practice, however, because a person who lends money to a limited company usually requires some security for his loan.

Debentures are usually secured by a floating charge on the undertaking and property of the company. A floating charge of this nature is peculiar to English company law. Normally a person who creates a charge on one of his assets is unable to dispose of that asset unless he repays the loan that is secured on it. If the owner of a freehold house mortgages it, he not only signs a mortgage deed, he also puts the title deeds into the hands of the lender or mortgagee. Where a floating charge is given, however, the company retains possession and control of all its assets and can sell or otherwise dispose of them.

In the ordinary course of business the sale of one asset leads to the acquisition of another (for example, the sale of trading stock gives rise to book debts or additional cash balances; these are used in turn to buy more goods, and so on) to which the floating charge in turn extends. The security enjoyed by the holder of a floating charge is thus not necessarily prejudiced by the company's freedom to dispose of its assets; where trading or other losses lead to a reduction in the total value of the assets which are subject to the charge, however, the security may become doubtful.

The terms of the debenture or other instrument creating the charge therefore gives the lenders the right to exercise their security on the happening of various events. These normally include failure to pay interest on the loan on the proper due dates, the presentation of a winding-up petition against the company and similar circumstances which indicate that the company is unable to meet its debts as they become due.

The security is enforced by obtaining the appointment of a receiver and the immediate effect of such action is that the charge "crystallizes" on all the assets for the time being. The company is no longer in a position to dispose of any assets which are subject to the charge, and they pass into the control of the receiver, who sells them for the benefit of the debenture holders for whom he is acting.

The practical effect of this is that holders of debentures which carry a floating charge rank in front of the ordinary unsecured creditors of the company; preferential creditors for rates, taxes, wages, salaries, etc.,

still rank in front of the debenture holders and must be paid in full by the receiver before he makes any distribution to the debenture holders.

If the company possesses fixed assets, such as freehold or leasehold premises, which are not already subject to a mortgage, it is not unusual to give debenture holders a fixed charge on such assets in addition to their floating charge on the undertaking as a whole. This ensures that even if trading and other losses lead to a disastrous loss of assets before the floating charge can be enforced, the assets subjected to the fixed charge cannot be disposed of by the company and will always be available to meet the claims of debenture holders.

REGISTRATION OF CHARGES

A charge on any assets or uncalled capital of a company must be registered with the Registrar of Companies within 21 days after the date of its creation; failing such registration it will become null and void as against a liquidator or creditor of the company.

The instrument creating the charge has to be delivered to the Registrar together with the following particulars:

(1) If the charge is a charge created by the company, the date of its creation, and if the charge was a charge existing on property acquired by the company, the date of the acquisition of the property.
(2) The amount secured by the charge.
(3) Short particulars of the property charged.
(4) The persons entitled to the charge.

If a series of debentures is involved, the charge is usually, but not necessarily, embodied in a trust deed. In that case either the deed, or if there is no such deed, one of the debentures, must be filed, together with the following particulars:

(1) The total amount secured by the whole series.
(2) The dates of the resolutions authorizing the issue of the series and the date of the covering deed, if any, by which the security is created or defined.
(3) A general description of the property charged.
(4) The names of the trustees, if any, for the debenture holders.

Particulars must also be given of any commission, allowance or discount paid or made either directly or indirectly by a company to any person in consideration of his subscribing or agreeing to subscribe or procuring or agreeing to procure subscriptions for any such debentures.

When a debt which is the subject of a charge is repaid in whole or in part, the Registrar of Companies will enter on the register a Memorandum of Satisfaction and, if so required, furnish the company with a copy.

Great importance is attached to the correct and prompt registration of charges created by a company as the rights of other parties, such as unsecured creditors, may be seriously prejudiced. The register is, of course, open to inspection by any person.

Double protection is afforded by the provision that every company, in addition to registering charges with the Registrar of Companies, must keep at its own registered office:

(1) a copy of every instrument creating a charge;

(2) a register of charges in which is entered any charge specifically affecting property of the company and all floating charges on the undertaking or any property of the company, giving in each case a short description of the property charged, the amount of the charge, and, except in the case of securities to bearer, the names of the persons entitled thereto.

(1) and (2) must both be open to the inspection of any creditor or member of the company without fee; other persons are entitled to inspect (2) only, on payment of a fee not exceeding 1s.

REGISTER OF DEBENTURE HOLDERS

Although debentures may be issued to bearer and such securities are popular in many foreign countries, they are not commonly issued in Great Britain. Except where bearer debentures are issued, the holder of debentures has to be registered as such; this involves entering his name in a Register of Debenture Holders and the issuing by the company of a certificate (similar to a share certificate) to the effect that he is the registered holder of so many debentures of a certain series.

The register of debenture holders is not to be confused with the company's register of charges, although the latter will, of course, contain particulars of any charge on the company's assets given to the holders of debentures. The register of charges must be kept at the company's registered office; the register of debenture holders on the other hand may, like the register of members, be kept at some other address, provided notice to that effect is given to the Registrar of Companies. It must be open to inspection by debenture holders or members of the company without fee and by other persons on payment of a fee not exceeding 1s.

REDEMPTION OF DEBENTURES

Although debentures are sometimes referred to as the loan capital of a company, a debenture is, of course, a form of indebtedness and as such is fundamentally different from share capital. Clearly it is not desirable that any restriction should be placed upon the ability of a company to pay off its debts, so the redemption of debentures is not subject to the strict control that is necessary in regard to the redemption of capital.

Primarily, the method and date of repayment are matters to be decided when the debentures are issued and to be incorporated in the provisions of the trust deed, if any. The date of redemption may be fixed or the company may be given the option of redeeming either not later than, or not earlier than, a given date.

Provision may or may not be made for the setting up of a sinking fund to provide for the cash necessary to effect the repayment; alternatively, a similar result may be obtained by periodical drawings. The redemption may be at par, at a premium over par, or at a discount according to the terms laid down; alternatively, the company may have the right to buy the debentures, or some of them, from the present holders at current market price and, having bought them, to cancel them.

Debentures which are issued on terms that they are to be irredeemable, or are to be redeemable only on the happening of a contingency, how-

ever remote, do not offend the general rules of law against perpetuities.

Debentures that have been redeemed by a company may be reissued by it unless there is any provision to the contrary, whether express or implied, in the Articles or in any contract entered into by the company. This does not apply, however, if the company has definitely cancelled the debentures, either by a resolution to that effect, or by some other act.

Where redeemed debentures are reissued, the new holder has the same priorities as if the debentures had never been redeemed. This may be of great importance when the company's assets have become subject to more than one charge.

Debentures are sometimes created and deposited with bankers or other persons as security for a loan on current account. Although the debenture so issued is expressed to secure a fixed sum, the actual liability of the company to the lender will vary from day to day, as, for example, where a debenture is deposited with the company's bankers to secure a fluctuating overdraft. At times the account may not be overdrawn but the debentures are not considered to have been redeemed merely for that reason. Consequently, when the account again goes into debit the debentures do not have to be reissued.

QUESTIONS AND EXERCISES

(Key to answers on page 570)

(1) What is a corporation? What are the essential differences between a partnership and a company incorporated under the Companies Acts?

(2) What are the principal steps to be taken to secure the registration of a company limited by shares? Are there any restrictions upon the choice of a name for such a company?

(3) Explain the difference between the Memorandum and the Articles of a company. What are the clauses of the Memorandum of a company limited by shares?

(4) (*a*) What is Table A? (*b*) What is the difference between a public and a private company?

(5) What is an exempt private company? What privileges does it enjoy?

(6) When is a company entitled to commence business?

(7) What is a prospectus and how does it differ from an offer for sale?

(8) Outline briefly the procedure necessary to effect an allotment of shares in a limited company.

(9) In what circumstances can shares be issued at (*a*) a premium; (*b*) a discount?

(10) What do you understand by (*a*) share certificates; (*b*) register of members; (*c*) reserve liability; (*d*) reduction of share capital.

(11) What are the main provisions of the Companies Act, 1948, regarding (*a*) annual meetings; (*b*) extraordinary general meetings?

(12) What is a proxy? What procedure governs the use of proxies at annual general meetings.

(13) How are directors (*a*) appointed; (*b*) removed?

(14) What principles of law govern the rights and duties of the directors of a limited company?

(15) What are the chief duties of the secretary of a company? What is a registrar?

(16) What is a debenture? Must a debenture always be registered; if so, how and where?

(17) What is an annual return? Whose duty is it to compile it and when and where must it be filed?

CHAPTER XII

COMPANY ACCOUNTS

(1) GENERAL

In a limited company the number of shareholders may be as few as two (in a private company) or as many as several thousand (in a large public company). The detailed records of the shares allotted to each shareholder, of the amounts paid and payable therefor and, in consequence, of the amount in respect of which he is entitled to receive his share of such dividends as may be declared, will be found in the Share Ledger and Register of Members. This is one of the statutory books the keeping of which is regarded as one of the duties of the secretary.

In the financial books the general principle is followed of recording shareholdings in total, the only separation necessary being as between the various classes of shares (if more than one class has been issued). Balance Sheets issued by a company similarly exhibit the total issued capital (or the total of each class of issued capital) and do not attempt to show the individual holdings comprising those totals.

The recording of capital in total is one of the principal points of difference between partnership accounts and company accounts. In a partnership each partner is individually responsible for the debts of the firm, and capitals are not necessarily contributed in the proportions in which profits and losses are shared. It is, therefore, important that there should be a separate and permanent record of the capital held by each partner. The balance of his capital account may be affected from time to time by capital sums paid in or withdrawn, by his share of profits (where separate current accounts are not kept) and by drawings.

None of these considerations applies in keeping the accounts of a company; on the contrary, the liability of a shareholder is limited to the amount he has agreed to subscribe for his shares. Once that amount has been paid he cannot be called upon to pay any more, but, on the other hand, his capital is not normally withdrawable. The capital of a company is, in a sense, a fixed fund. It can be increased by further issues of capital from time to time, but can only be withdrawn in the event of liquidation (and then only after all prior claims have been met) or in the special circumstances considered hereafter.

The profits of a company do not affect the *issued* capital as they do not belong to the shareholders until, and to the extent that, they are declared in dividends. These dividends are also recorded in total in the financial books; any undistributed balance of profits is carried forward on Profit and Loss Appropriation Account.

SHARE CAPITAL ACCOUNTS

When the capital of the company is not divided into different classes of shares, one account in the General Ledger (or Private Ledger) called Share Capital Account will be sufficient.

If shares of more than one class are issued, however, either concurrently or at various dates, care must be taken to open separate Capital Accounts for each class. The titles of the accounts should indicate, in reasonable detail, the nature of the shares, for example:

6 per cent Cumulative Preference Share Capital Account
5 per cent Participating Preference Share Capital Account
A Ordinary Share Capital Account
B Ordinary Share Capital Account

It is also usual to make a note, at the head of each account, of the total *authorized* capital of that class, as this information has to be given in each Balance Sheet. Apart from a possible note of this nature, unissued capital is not recorded in the financial books of a company (nor does it enter into the effective totals of the Balance Sheet).

Further, where capital is issued on terms that it is not to be paid up in full at once, so that there is a balance of uncalled capital, the amount recorded in the financial books and exhibited in the company's Balance Sheets is the amount of the *called-up capital* for the time being. Although in such cases the directors might, subject to the Articles and terms of issue, make a call at any time and thus increase the company's assets by the proceeds of the call, this amount is not regarded as an asset until the call has been made. The fact that the shares are not fully called up is, of course, indicated in the description given in the Balance Sheet, for example, "Issued Share Capital—10,000 Ordinary Shares of £1 each, 5s. per share called up, £2,500."

SHARES ISSUED FOR CASH—PRIVATE ISSUES

Where shares are issued for cash and are paid for in full on application, there being no public issue or offer for sale, the formality of issuing letters of allotment is usually dispensed with, the share certificates being issued at once in exchange for the appropriate cash payments. The entry of the cash received, in the Cash Book, followed by a posting to the credit of the appropriate Share Capital Account, is the simplest way of recording the transaction and in these circumstances is the best.

Example

A and B formed a small private company, A & B Ltd., to work a process in which they were both interested. On March 1 A paid in £400 and B paid in £300 to the company's bank account, and at a board meeting on the same day they allotted themselves 400 and 300 Ordinary shares of £1 each, fully paid. The only necessary entries in the financial books are as follows:

CASH BOOK

19—		£			
March 1	To Ordinary Share Capital A/c:				
	A for 400 shares	400			
	B for 300 shares	300			

			19— March 1	By Cash: A for 400 f.p. shares B for 300 f.p. shares	£ 400 300

It will be noticed that as two cheques are paid in they are, in a sense, recorded separately, and in this case the Share Capital Account does show the amount subscribed by each shareholder. When the account is balanced at the end of the year, however, one balance only, of £700, will go forward to the next period, and the Balance Sheets of the company (assuming there to be no further issues of capital) will show "Ordinary Share Capital, issued and fully paid, 700 Shares of £1 each, £700."

If, in the foregoing example, the capital had been subscribed by, say, twenty different shareholders, the same procedure could have been followed, or, alternatively, a subsidiary column of the Cash Book (debit side) could have been used to list the cheques, and the total of this column would then be posted to Ordinary Share Capital Account as "By Cash—Sundry Shareholders."

SHARES ISSUED FOR CASH—PUBLIC ISSUES

A public issue of shares, which can, of course, be made only by a public company, frequently provides for a certain amount per share to be paid on application. Either the whole of the balance is then payable on allotment, or, alternatively, there may be a further payment on allotment, followed by calls or instalments at later dates. The principles involved in framing the correct entries in the financial books are then as follows:

(1) There is no binding contract between the company and an applicant for shares until the directors have proceeded to allotment, and allotment letters have been posted.

(2) There is, therefore, no *issue* of capital until the date of allotment.

(3) The amount paid by an applicant on application may have to be returned to him in certain events, either in whole or in part. Between the date of application and the date of allotment, therefore, the deposits received by the company should be treated as a liability; they cannot, at this stage, be credited to Share Capital Account.

(4) Where, as is often the case, the number of shares allotted to an applicant is less than the number applied for, the amount overpaid on application will be applied towards the amount, if any, payable by that applicant on allotment. Entries relating to application and allotment are therefore combined in one account called Application and Allotment Account.

(5) If further calls or instalments will be payable at later dates, money overpaid on application and allotment (such overpayments arise, normally, where there has to be a heavy scaling down of the allot-

ments) is *not* retained on account of the next call or instalment but is returned to the applicant immediately. Separate accounts are, therefore, opened for each call or instalment as it becomes due.

(6) The Application and Allotment Account and any necessary Call Accounts represent, in total, the liability of the shareholders to pay to the company the various amounts due on the relative dates. These accounts are thus closed automatically when the total amount due on each date has been received. The total called-up value of the capital issued is recorded, as usual, in the appropriate Share Capital Account.

(7) It is usual to open special bank accounts to receive the amounts payable on the various dates; indeed, the terms of issue usually provide for payment to be made to the company's bankers, who then give any necessary receipts to the shareholders. The entries in the company's General Cash Book, which alone affect the double entry, will then be restricted to recording the various totals transferred from time to time from the special accounts.

Example (*a*)

Croesus Gold Mines, Ltd., made an issue of £1 Ordinary shares at par, payable 2s. 6d. per share on application, 7s. 6d. per share on allotment, 5s. per share on June 1 and 5s. per share on October 1. Applications were received on March 10 for 200,000 shares, which were allotted in full on March 15. All monies due on allotment and call were received within 10 days of the due dates. Make the necessary entries in the company's books, in the form of journal entries:

			£	£
March 10	Cash To Application and Allotment A/c being 2s. 6d. per share received on application for 200,000 Ordinary shares of £1 each	Dr.	25,000	25,000
March 15	Application and Allotment A/c To Ordinary Share Capital A/c being 2s. 6d. per share payable on application plus 7s. 6d. per share payable on allotment in respect of 200,000 Ordinary shares of £1 each, numbered 1 to 200,000, issued in accordance with Directors' resolution of this date	Dr.	100,000	100,000
March 25	Cash To Application and Allotment A/c being balance 7s. 6d. per share, received on allotment of 200,000 Ordinary shares, as above	Dr.	75,000	75,000
June 1	1st Call (or Instalment) A/c To Ordinary Share Capital A/c being instalment of 5s. per share on 200,000 Ordinary shares	Dr.	50,000	50,000

June 10	Cash Dr. To 1st Call A/c being cash received in respect of first call, as above		50,000	50,000
Oct. 1	2nd Call A/c Dr. To Ordinary Share Capital A/c being final instalment of 5s. per share on 200,000 Ordinary shares		50,000	50,000
Oct. 12	Cash Dr. To 2nd Call A/c being cash received in respect of second (and final) call, as above		50,000	50,000

Example (*b*)

South Sea Bubbles, Ltd., in June issued a prospectus inviting applications for 500,000 Ordinary shares of £1 each at par and payable as to 10s. per share on application and 10s. per share on allotment. Applications were received on June 15 for a total of 1,500,000 shares and the directors proceeded to allotment on the following basis:

Applications for 100,000 shares—allotted in full.
,, ,, 400,000 ,, —one-half allotted.
,, ,, 800,000 ,, —one-quarter allotted.
,, ,, 200,000 ,, —received no allotment.

Allotment letters were posted on June 20 and all monies due to or from the company were paid on or before June 30. Show the necessary entries in the company's Cash Book and ledger.

As the necessary entries should be made in total it is advisable to make a preliminary calculation as follows:

Number of Shares		*Amount paid on application* (10s. *per share*)	*Total payable on application and allotment* (£1 *per share*)	*Balance due*	
Applied for	*Allotted*			*to the Company*	*from the Company*
		£	£	£	£
100,000	100,000	50,000	100,000	50,000	—
400,000	200,000	200 000	200,000	—	—
800,000	200,000	400,000	200,000	—	200,000
200,000	—	100,000	—	—	100,000
1,500,000	500,000	£750,000	£500,000	£50,000	£300,000

(General) Cash Book

		£			£
June 15	To Application and Allotment A/c	750,000	June 30	By Application and Allotment A/c	300,000
30	,,	50,000			

ORDINARY SHARE CAPITAL ACCOUNT

					£
			June 20	By Application and Allotment A/c (500,000 shares fully called)	500,000

APPLICATION AND ALLOTMENT ACCOUNT

		£			£
June 20	To Ordinary Share Capital A/c	500,000	June 15	By Cash	750,000
30	Cash	300,000	30	,,	50,000
		£800,000			£800,000

SHARES ISSUED AT A PREMIUM OR DISCOUNT

When shares are issued at any price other than their par value, the general principle to be followed is that the appropriate Share Capital Account must record the amount which is being credited as paid-up as capital. This result can only be achieved by recording any premium or discount on issue in a separate account. A separate record of the premium or discount is also necessary in order to ensure that the subsequent treatment of the premium or discount is correct, in accordance with the provisions of the Companies Acts.

Example

If, in the example on page 231, Croesus Gold Mines, Ltd., had issued the 200,000 Ordinary shares of £1 each at £1 2s. 6d. per share, the amount payable on allotment being increased to 10s. per share and including the premium, the second and third journal entries would be amended as follows:

		£	£
March 15	Application and Allotment A/c Dr. To Ordinary Share Capital A/c Share Premium A/c being 2s. 6d. per share payable on application plus 10s. per share (including premium of 2s. 6d. per share) payable on allotment in respect of 200,000 Ordinary shares of £1 each numbered 1 to 200,000 issued at a premium of 2s. 6d. each in accordance with Directors' resolutions of this date.	125,000	 100,000 25,000
March 25	Cash Dr. To Application and Allotment A/c being 10s. per share received on allotment of 200,000 Ordinary shares.	100,000	 100,000

SHARES ISSUED FOR THE CONSIDERATION OF ACQUISITION OF A BUSINESS

When a company is formed to take over an existing business, or when an existing company seeks to extend its activities by taking over an additional business, it is not uncommon for the vendors (that is, the owner or owners of the business that is to be sold to the company) to take part, or even the whole, of the purchase price in the form of shares in the company. The company is then said to issue shares for a consideration other than cash.

Where a Return of Allotments (see page 205) discloses that any shares have been issued for a consideration other than cash, the Registrar requires the company to file the contract under which the shares are being allotted to the vendors. Where no formal contract has been executed, a form is provided on which the necessary details are recorded; this form is then subject to *ad valorem* stamp duty on the same scale as a contract for sale.

Consequently, although the original agreement may merely have provided that the whole business was to be transferred as a going concern, for a total consideration of the amount stated, it is necessary to say how much of this price relates to each asset (or class of asset) that is to be acquired. The excess, if any, of the total consideration over the separate values of the tangible assets that are actually transferred to the company is then regarded as being paid for the goodwill of the business.

In exceptional cases where the value of the assets exceeds the purchase consideration, the difference is normally carried to Capital Reserve; if it is known to be attributable to an over-valuation of any of the assets it can be applied in reducing that valuation.

Apart from the question of filing the agreement for sale, and the resulting liability to *ad valorem* stamp duty, it is necessary to know how much was paid for each class of asset in order to record its acquisition in the books of the company. An opening journal entry is required and it is usually advisable, save in the simplest cases, to divide this into two or more parts, of which the first records the acquisition of the assets and the others show how the purchase consideration has been discharged.

Example (*a*)

Barnaby Rudge, whose Balance Sheet on December 31 was as follows:

	£			£
Sundry Creditors	1,000	Freehold Premises		5,000
E. Chester, Loan	2,000	Plant and Machinery		3,000
B. Rudge, Capital	9,000	Stock-in-Trade		2,000
		Sundry Debtors	£1,600	
		Less Provision for Bad Debts	100	
				1,500
		Cash at Bank		500
	£12,000			£12,000

agreed on that date to sell his business to a limited company, Grip, Ltd., that had been formed for the purpose. The authorized capital of the company was £20,000, divided into 10,000 Ordinary shares and 10,000 Preference shares of £1 each. E. Chester agreed to take 2,000 Preference shares in satisfaction of his loan and W. Haredale subscribed for 3,000 Preference shares at par. The company took over all the assets, including cash at bank, at the value shown in Rudge's Balance Sheet, except that it was agreed to revalue the freehold premises at £7,000. The purchase consideration payable to Rudge was £2,000 in cash and the allotment to him of 10,000 Ordinary shares and 2,000 Preference shares at par, in addition to the Preference shares allotted to Chester in respect of his loan. The company also agreed to discharge the liabilities to Sundry Creditors.

Give the journal entries necessary to record the foregoing in the books of the company and draft a *pro forma* Balance Sheet as on January 1.

JOURNAL

			£	£
Jan. 1	Goodwill	Dr.	3,000	
	Freehold Premises		7,000	
	Plant and Machinery		3,000	
	Stock-in-Trade		2,000	
	Sundry Debtors		1,600	
	Cash at Bank		500	
	To Sundry Creditors			1,000
	Provision for Bad Debts			100
	Vendors A/c (B. Rudge)			16,000
	being assets acquired and liability to creditors assumed under sale agreement between B. Rudge and the Company.		£17,100	£17,100
Jan. 1	Vendors A/c	Dr.	2,000	
	To Preference Share Capital A/c			2,000
	being allotment of 2,000 Preference shares to E. Chester in satisfaction of his loan to B. Rudge.			
Jan. 1	Vendors A/c	Dr.	14,000	
	To Cash			2,000
	Ordinary Share Capital A/c			10,000
	Preference Share Capital A/c			2,000
	being satisfaction of balance of purchase consideration by payment of cash and allotment of shares to B. Rudge			
Jan. 1	Cash	Dr.	3,000	
	To Preference Share Capital A/c			3,000
	being allotment of 3,000 Preference shares at par to W. Haredale and cash paid by him			

GRIP, LTD.

Pro forma Balance Sheet as on January 1

Authorized Share Capital:	£	Fixed Assets, at cost:	£	£
10,000 Pref. shares of £1 each	10,000	Goodwill	3,000	
		Freehold Premises	7,000	
10,000 Ord. shares of £1 each	10,000	Plant and Machinery	3,000	13,000
	£20,000			
Issued Share Capital:		Current Assets:		
7,000 Pref. shares of £1 each, fully paid	7,000	Stock-in-Trade	2,000	
10,000 Ord. shares of £1	10,000	Sundry Debtors 1,600 *Less* Provision for Bad Debts 100	1,500	
	17,000	Cash at Bank	1,500	
Sundry Creditors	1,000			5,000
	£18,000			£18,000

Notes. (1) The amount attributable to goodwill is the £3,000 necessary to make the first journal entry balance. Alternatively, it may be calculated as follows:

The consideration receivable by Rudge personally is	£14,000
as against a balance on his Capital Account of	£9,000
he thus makes a "profit on sale" of	£5,000
of which the amount attributable to the revaluation of freehold premises is	£2,000
Therefore the amount received by Rudge for the goodwill of his business is	£3,000

(2) The treatment of the item Sundry Debtors should be noted. As this asset is taken over at its value in Rudge's Balance Sheet, the debts totalling £1,600 are considered to be worth only £1,500. Nevertheless, they are brought into account on the debit side at their face value because they will all have to be taken into the company's Sales Ledger. (In all probability the company will take over and continue in use the Sales Ledger used by Rudge; the £1,600 is then the total of the existing balances and this item does not have to be posted from the journal entry.) To reduce the £1,600 to the agreed value of £1,500 the company therefore creates immediately a Provision for Bad Debts as a credit balance in its General Ledger.

(3) The company does not take over the liability of £2,000 to Chester. This is a personal liability of Rudge which is discharged by the allotment of 2,000 Preference shares in the company; the allotment of these shares is, therefore, regarded as part of the total purchase consideration payable to Rudge.

Example (b)

After Grip, Ltd., had been in existence for several years its Balance Sheet (in outline) on September 30 was as follows:

	£		£
Issued Share Capital:		Sundry Assets (includin[illegible] Goodwill, at cost £3,[illegible]00)	30,000
7,000 Preference shares	7,000		
10,000 Ordinary shares	10,000		
	17,000		
Profit and Loss A/c	10,000		
Sundry Creditors	3,000		
	£30,000		£30,000

Varden's Balance Sheet on the same date showed the following position:

	£		£
Sundry Creditors	2,000	Goodwill	10,000
Bank Overdraft	500	Stock-in-Trade	6,000
G. Varden, Capital	18,000	Sundry Debtors	4,500
	£20,500		£20,500

Grip, Ltd., agreed to acquire Varden's business on these terms:

(1) To take over his stock-in-trade at book value and his book debts at a valuation of £4,000.

(2) To pay £4,000 for his goodwill.

(3) Of the total consideration of £14,000, £4,000 was to be paid in cash and £10,000 by the allotment of Ordinary shares in Grip, Ltd.

(4) Out of the cash consideration, Varden was to discharge his own liabilities, including the bank overdraft.

(5) In view of the large balance of undistributed profits of Grip, Ltd., its existing Ordinary shares were agreed to be worth £2 per share; the £10,000 was, therefore, satisfied by the allotment of 5,000 £1 Ordinary shares at a premium of £1 per share.

Draft the necessary journal entry in the books of Grip, Ltd., to give effect to the foregoing.

JOURNAL

			£	£
Sept. 30	Goodwill	Dr.	4,000	
	Purchases		6,000	
	Sundry Debtors		4,500	
	To Provision for Bad Debts			500
	Cash			4,000
	Ordinary Share Capital A/c			5,000
	Premium on Shares A/c			5,000
	being acquisition of Varden's business as per agreement of this date		£14,500	£14,500

The fact that the contract for sale of a business to a company entails payment of *ad valorem* stamp duty may add substantially to the cost of the transaction. To keep this cost to a minimum, it may therefore be agreed that the company shall not take over the book debts of the vendor, the purchase consideration being to that extent lower than it would otherwise have been.

If the vendor collects the outstanding debts himself all the records of this will be in his books (that is, in his Cash Book and Sales Ledger), which will be kept open for that purpose. In such a case the company could not very well take over the old Sales Ledger and would have to start its own with entirely new accounts. This would mean that for several months at least two sets of monthly statements would have to be sent out—one by the vendor for all balances due up to date of the sale and another set by the company for new balances arising since that date. This may prove confusing and inconvenient to the customers, who will regard the account as having continued without a break, and in the ordinary course of business they will wish to deal with one office only.

The usual procedure where the company does not actually take over the book debts, therefore, is for it to agree to collect these debts as agent for the vendor. All monies received will then pass through the company's Cash Book and for the first few months it will be advisable to provide an additional analysis column on the debit side in order to record the amount collected in this way. The double entry is completed by posting the total of this column periodically to the credit of Vendor's Account. The individual amounts collected will, of course, have to be posted to the credit of the appropriate Sales Ledger accounts, but these postings are really of a memorandum nature, as the old balances have not been incorporated in the company's double entry.

Where book debts are collected by the company as agent for the vendor the agreement may very well provide that, out of the proceeds, the company shall pay the vendor's liabilities. The book-keeping principles involved are similar, an additional analysis column being provided on the credit side of the Cash Book and posted in total to the debit of Vendor's Account.

Under the system outlined, discounts and (in the case of Sundry Debtors) bad debts arising from the vendor's balances will not affect the company's double entry. Nevertheless, it may be advisable to provide additional (memorandum only) columns in the Cash Book for a few months to record such discounts and facilitate the posting to the old accounts. So far as the company is concerned, its liability is restricted to accounting to the vendors for the cash actually received from debtors, less, where appropriate, amounts paid on the vendor's behalf to his creditors or otherwise.

A system of book-keeping under which certain entries are only of a memorandum nature and do not affect the double entry is apt to be confusing and to lead to errors both in its detailed execution and in attempting to balance the books at a later date. An alternative method

by which the vendor's debtors (and creditors), although not strictly taken over by the company, are nevertheless incorporated in its double-entry book-keeping system, can therefore be recommended. This has the additional advantage of facilitating the use by the company of the old Personal Ledgers without any break in the accounts at the date of transfer of the business.

The method involves the opening and subsequent operation of Suspense Accounts to balance out the figures of debtors and creditors which are taken into the company's books.

Example

The example on page 237 is amended as follows:

(1) The company agrees to allot to Varden 5,000 Ordinary shares at £2 per share as consideration for the transfer of his goodwill (£4,000) and stock-in-trade (£6,000).

(2) The company agrees to collect the outstanding book debts on his behalf and out of the proceeds to defray his liabilities to Sundry Creditors. Varden pays off the overdraft himself out of his private resources.

(3) At the expiration of three months the position in regard to Varden's debtors and creditors was as follows:

		£
Debtors—	Cash received by company	3,500
	Discounts allowed on above items	300
	Bad debts written off	400
Creditors—	Cash paid by company	1,920
	Discounts deducted	80

Show the journal entries arising from the acquisition of Varden's business and the collection and payment of his balances.

JOURNAL

			£	£
Sept. 30	Goodwill	Dr.	4,000	
	Purchases		6,000	
	To Ordinary Share Capital A/c			5,000
	Premium on Shares A/c			5,000
	being acquisition of Varden's goodwill and stock-in-trade as per agreement of this date		£10,000	£10,000
Sept. 30	Sundry Debtors	Dr.	4,500	
	To Vendor's Debtors Suspense A/c			4,500
	being vendor's book debts to be collected by the Company on his behalf			
Sept. 30	Vendor's Creditors Suspense A/c	Dr.	2,000	
	To Sundry Creditors			2,000
	being vendor's liabilities to be discharged by the Company on his behalf			

Dec. 31	Vendor's Debtors Suspense A/c	Dr.	4,200	
	To Vendor (Varden)			3,500
	Discounts Allowed			300
	Bad Debts			400
	being vendor's book debts collected to date and discounts and bad debts written off in respect of his accounts			
Dec. 31	Vendor (Varden)	Dr.	1,920	
	Discounts Received		80	
	To Vendor's Creditors Suspense A/c			2,000
	being vendor's liabilities discharged on his behalf and discounts received on payment thereof			

Note. The effect of the above entries in regard to the collection and payment of balances on behalf of the vendor is as follows:

(1) The vendor is credited with the amount actually received by the company (£3,500) and debited with the amount actually paid on his behalf (£1,920). The resulting credit balance of £1,580 on Vendor's Account is thus the actual liability of the company to him, and the account will be closed (for the time being) if the company pays him this sum.

(2) All amounts received from customers were entered in the Cash Book in the normal way whether they related to old (vendor's) balances or to new (company's) transactions. The discounts allowed on the old balances have thus become merged in the discounts allowed by the company itself and have been debited (as part of a larger total) to Discounts Allowed Account. This loss of £300 should not fall upon the company, however, but upon the vendors; the fourth journal entry secures that result.

(3) Similarly, the bad debts were written off in the first instance by transfer to the debit of Bad Debts Account in the company's ledger. This loss also should fall upon the vendor.

(4) Similar, but reverse, considerations apply in regard to the £80 discount allowed by the vendor's creditors.

(5) The credit of £2,000 to Vendor's Creditors Suspense Account in the last journal entry closes that account, which is correct because all the old creditors have been paid.

(6) The debit of £4,200 to Vendor's Debtors Suspense Account in the penultimate journal entry, however, leaves a balance of £4,500 − £4,200 = £300 on that account. This represents the book value of the outstanding old balances that have been neither written off nor collected. These balances will be included in the general list of Sales Ledger balances when the Trial Balance of the company's books is taken out as on December 31. Let it be supposed that the total of the list of Sundry Debtors is £7,800; then £300 of this represents old balances belonging to Varden and £7,500 represents balances actually due to the company in its own right.

When the company's Balance Sheet on December 31 is drafted the £300 *credit* balance on Vendor's Debtors Suspense Account will be deducted from the total of the Sales Ledger *debit* balances, leaving a net figure of £7,500 (subject to any provision for bad debts that the company may decide upon) to appear as Sundry Debtors.

A company cannot, in fact, own a business or do anything at all before it is incorporated. Once it has been incorporated and (as regards public companies only) has obtained the Registrar's certificate entitling it to commence business, it may, however, enter into a contract under which it takes over a business as from some earlier date. That date would normally be the last date up to which the vendor prepared accounts; investors in the company will then be able to see what they are acquiring in the form of a Balance Sheet, which would not be possible if the contract provided for the taking over of the business as from some future date.

A company would not normally take over a business unless there were a reasonable prospect of profits arising from carrying it on. If, therefore, the company takes over a business as from some past date, the purchase consideration, whether it be in shares or cash or both, is really paid for:

(1) the assets of the business as at the date from which it is deemed to be taken over; plus
(2) the benefit of any profits earned since that date.

Thus, the capital of the company is used, in part, to acquire the profits of a certain period; the receipt of these profits is consequently a recoupment of that part of the capital expenditure. It follows that where a company takes over a business from some date earlier than that of its own incorporation, it must treat any profit for that period (that is, up to date of incorporation) as a capital profit which is not available for distribution to the shareholders as dividend on their shares.

The pre-incorporation profit is capitalized by transferring it to Capital Reserve, or it may alternatively be applied in reduction of the cost of goodwill in cases where the purchase consideration exceeded the value of the tangible assets acquired. Before such a transfer can be made, however, the profit must be calculated.

If a Profit and Loss Account can be prepared for the broken period up to the date of incorporation of the company, the exact amount of the profit to be capitalized will be known. The first Profit and Loss Account of the company as such will then commence on the date of incorporation and the whole of the profit disclosed by it will be available for distribution (it does not follow, of course, that the whole of it will in fact be distributed). It would necessarily follow, in such a case, that a Balance Sheet of the vendor's business as at the date of acquisition would be available and this would provide the necessary information for opening the company's books.

In many cases, however, it will not prove possible to prepare accounts for the broken period up to the date of incorporation. The first Profit and Loss Accounts prepared by the company will then commence as from the date of the vendor's last Balance Sheet, that being the date from which the company is deemed to have acquired the business. This account will thus cover two broken periods—one starting at the date of the vendor's last Balance Sheet and terminating on the date of incorporation of the company; the other commencing on the latter date and terminating at the date chosen for the company's first Balance Sheet.

If the company adopts the same accounting date as that used by the vendor, the total period covered by the Profit and Loss Account will be one year. The company is, however, free to choose any other date, within the limits laid down by the Acts.

The profit for the period ending on the date of incorporation then has to be found by apportioning the profit disclosed for the whole period. In most cases it will be sufficient to apportion the net profit by reference to the periods of time disclosed.

Example

In the example on page 234, if Grip, Ltd., which took over Barnaby Rudge's business as from December 31, was not incorporated until April 1 following that date, and the Profit and Loss Account for the year ended on December 31 following showed a net profit of £4,000, then, by simple proportion, the profit for the three months prior to incorporation of the company is deemed to have been one quarter of £4,000 = £1,000.

The net profit will be carried down to an Appropriation Account, from which £1,000 will then be transferred to Capital Reserve, as follows:

GRIP, LTD.

Profit and Loss Appropriation Account
for the year ended December 31

	£		£
To Transfer to Capital Reserve, being profit for period prior to incorporation	1,000	By Net Profit for the year ended Dec. 31	4,000
Balance, carried forward	3,000		
	£4,000		£4,000

In some cases, however, and more particularly where the business is of a seasonal nature, a simple time-basis apportionment of the net profit does not give a fair result. The problem must then be dealt with on its merits, bearing in mind that in practice the detailed records from which the total Profit and Loss Account has been built up are always available for inspection.

Example

Squibs and Rockets, Ltd., was incorporated on January 5 to take over, as from the preceding November 5, the business of G. Fawkes, fireworks manufacturer. The first Profit and Loss Account prepared by the company, covering the year ended November 5, was as follows:

	£		£
To Rent, Rates and other Standing Charges	6,000	By Gross Profit	15,000
Commission on Sales	1,000	Discounts Received	100
Bad Debts	200		
Amortization of Lease	300		
Directors' Fees	500		
Discounts Allowed	400		
Interest payable to Vendor	150		
Net Profit	6,550		
	£15,100		£15,100

The total value of the sales effected during the year was £100,000, of which £10,000 related to the period of two months before the date of incorporation. Interest was payable to the vendor for the period November 5 to February 5, the purchase consideration being paid on the latter date.

In the absence of any further information, the best method of computing the profit prior to incorporation would be as follows:

APPORTIONED PROFIT AND LOSS ACCOUNT

	Nov. 6 to Jan. 4	*Jan. 5 to Nov. 5*		*Nov. 6 to Jan. 4*	*Jan. 5 to Nov. 5*
	£	£		£	£
To Rent, Rates and other Standing Charges	1,000	5,000	By Gross Profit	1,500	13,500
Commission on Sales	100	900	Discounts Received	10	90
Bad Debts	20	180			
Amortization of Lease	50	250			
Directors' Fees		500			
Discounts Allowed	40	360			
Interest payable to Vendor	100	50			
Net Profit	200	6,350			
	£1,510	£13,590		£1,510	£13,590

The bases of apportionment are as follows:

(1) Gross profit, commission on sales, bad debts and discounts in the turnover ratio of £10,000 to (£100,000 − £10,000) or 1 : 9, since these items will tend to vary in proportion to the value of goods sold.

(2) Rent, rates and other standing charges and amortization of lease on the time basis of 1 : 5, since these charges remain constant from

one month to another, and do not vary in proportion to the turnover.

(3) Directors' fees can relate only to the period when the company, as such, was in existence.

(4) Interest is charged according to the periods to which it relates.

PRELIMINARY EXPENSES

Expenses such as company registration fees and capital duty, and the cost of preparing and printing the Memorandum and Articles of Association and other documents necessary in the process of forming a company, are known as Preliminary Expenses. These expenses are, of necessity, incurred before the company is brought into being, but the person who incurs them is entitled to be reimbursed by the company unless he has agreed to bear them himself.

From the point of view of the company this expenditure is capital expenditure, since it is incurred once and for all in the process of bringing the company into existence. On the other hand, it differs from most other forms of capital expenditure in that no tangible asset is acquired in return. For this reason most companies endeavour to write off the preliminary expenses in as short a time as possible. This writing off is, of course, an appropriation of profits; it cannot be regarded as an expense incurred in earning the profit of the first or any other year.

A special account should be opened in the General Ledger to record the preliminary expenses until such time as they have been wholly written off. This account is sometimes referred to as a "fictitious asset," because although the balance on it at any time has to appear on the assets side of the Balance Sheet, it has no real value. The writing off of the whole or part of this balance will be effected by transferring the appropriate amount from the credit of Preliminary Expenses Account to the debit of Profit and Loss Appropriation Account.

ISSUE EXPENSES

If a public company makes an issue of shares or debentures, further capital expenditure may be incurred in so doing. The cost of printing and circularizing the prospectus, fees paid for professional reports and valuations published in the prospectus, legal expenses, printing and preparing allotment letters and original share certificates may all be capitalized under the heading of Issue Expenses. The treatment of Issue Expenses Account in the company's books will be similar to that described in relation to preliminary expenses, and until such time as it has been written off any balance on Issue Expenses Account must also be disclosed as a separate item in the annual Balance Sheets of the company.

UNDERWRITING AND COMMISSIONS ON PLACING SHARES

Public issues of shares and debentures are usually "underwritten." Underwriters, in return for a commission on the value of the shares underwritten, agree to take up themselves a rateable proportion of any shares or debentures not subscribed by the public. For example, if in respect of a public issue of 100,000 shares applications are received from

the public for 60,000 shares, a person who has underwritten 2,000 shares will be liable to take up and pay for (on the same terms as were offered to the public) 800 shares, being 40 per cent (the proportion of the total issue not subscribed by the public) of the 2,000 shares underwritten by him.

The commission paid to underwriters must not exceed 10 per cent of the issue price of the shares or debentures or such *lower* rate as may be fixed by the company's Articles.

As an alternative to a public issue underwritten in this way, a commission, not exceeding the maximum that could have been paid to an underwriter of the issue, can be paid to stockbrokers or other persons who obtain applications for shares or debentures from prospective shareholders.

Although in many respects underwriting commissions and commissions on placing shares or debentures can be regarded as issue expenses, they should be recorded in a separate account in the company's books, so that the obligation to disclose them (again until such time as they have been written off) in the company's Balance Sheets can be carried out.

BROKERAGE

The practice of paying a small brokerage on applications for shares or debentures which bear the stamp of a banker or broker should not be confused with the payment of a commission on placing shares or debentures.

The rate of brokerage does not usually exceed $2\frac{1}{2}$ per cent and may be very much less. Brokerage and underwriting commission may, in fact, be paid in respect of the same issue. The brokerage should be recorded in Issue Expenses Account.

FORFEITURE AND REISSUE OF SHARES

Subject to the provision of a company's Articles, its directors have power to forfeit shares for non-payment of calls and instalments. The effect of the forfeiture is to reduce the company's issued capital by the called-up value of the shares forfeited. They remain part of the authorized capital, however, and, again subject to the company's Articles, can be reissued at any time.

The book-keeping entries, and the effect upon the company's Balance Sheets, are reflected in the following example.

Example (*a*)

Dud Mines, Ltd., was incorporated on April 1 and issued 100,000 Ordinary shares of £1 each, payable as to 10s. per share on application and allotment, 5s. per share on July 1 and 5s. per share on September 1. The holders of 4,000 shares failed to pay either of the two instalments of 5s. per share and the holder of a further 1,000 shares failed to pay the final instalment only. After taking the necessary legal steps, the directors forfeited these 5,000 shares on January 31. The journal entries required to give effect to the forfeiture are as follows:

		£	£
Jan. 31	Ordinary Share Capital Dr. To Forfeited Shares A/c being forfeiture of 5,000 shares of £1 each for non-payment of calls, as per Minute of this date	5,000	5,000
Jan. 31	Forfeited Shares A/c Dr. To 1st Call Account 2nd Call Account being unpaid calls on shares forfeited as above	2,250	1,000 1,250

A Balance Sheet taken out on December 31 would have contained the following entries relating to share capital:

	£	£
Issued Share Capital:		
100,000 Ordinary Shares of £1 each fully called up	100,000	
Less Calls in Arrear	2,250	
		97,750

In the Balance Sheet at March 31, however, the following will appear:

	£
Issued Share Capital:	
95,000 Ordinary Shares of £1 each fully paid up	95,000
Forfeited Shares Account	2,750

It will be observed that the credit balance on Forfeited Shares Account represents the amount actually received by the company in respect of the shares before they were forfeited, namely:

On 4,000 shares, 10s. per share	2,000
,, 1,000 ,, 15s. ,, ,,	750
	£2,750

Example (*b*)

On the following June 1 the directors reissued the shares to X, credited as fully paid at 12s. 6d. per share. The journal entry necessary to record this is as follows:

		£	£
June 1	Cash Dr. Forfeited Shares Account To Ordinary Share Capital being re-issue to X at 12s. 6d. per share of 5,000 forfeited shares as per Minute	3,125 1,875	5,000

This leaves a balance of £875 standing to the credit of Forfeited Shares Account, representing the total amount of cash received by the company for the shares in excess of their full paid-up value, namely:

	£
Received from original shareholders as in (*a*)	2,750
" " X	3,125
	5,875
Less 5,000 shares at £1 per share fully paid	5,000
	£875

This balance of £875 is, therefore, in the nature of a share premium and it should be treated accordingly.

A Balance Sheet taken out at June 30 would show the following:

	£	
Issued Share Capital:		
100,000 Ordinary shares of £1 each fully paid	100,000	
Premium on Shares	875	

Where shares which were originally issued at a premium are subsequently forfeited for non-payment of calls, it is not necessary to disturb the balance on Share Premium Account if the premium had been received by the company before the shares were forfeited. If the premium has not been received, however (for example, where it was included in the allotment money which has not been paid), it must be written back to Forfeited Shares Account.

REDEEMABLE PREFERENCE SHARES

An issue of Redeemable Preference shares does not call for any special treatment, but the earliest date on which the company has power to redeem the shares should be noted at the head of Redeemable Preference Share Capital Account so that this information can be given in subsequent Balance Sheets.

The terms of issue and redemption of such shares are primarily a matter to be laid down in the company's own Articles. So far as redemption is concerned, however, the company's own regulations are subject to the following provisions:

(1) No share can be redeemed unless it has become fully paid up.

(2) The redemption must be effected either out of the proceeds of a new issue of shares or out of profits which would otherwise have been available for payment of dividends.

(3) The shares can be redeemed at a premium, but only if such premium is provided out of profits or out of a balance on Share Premium Account.

The redemption of Preference shares in accordance with the foregoing rules does not have the effect of reducing the authorized share capital of the company; consequently, a new issue of shares may be made

at a later date without payment of capital duty, provided it does not have the effect of increasing the company's capital above the amount of the authorized capital on which duty has already been paid. If, however, the redemption is to be effected out of the proceeds of a new issue, the latter can be made up to one month before the redemption and still be exempt from capital duty.

Example (a)

Redemption, Ltd., made an issue of 100,000 Ordinary shares of £1 each at par for the purpose of redeeming 100,000 6 per cent Redeemable Preference shares of £1 each. A premium of 2s. per share was payable on redemption. The following journal entries show how these transactions will be recorded:

		£	£
Cash	Dr.	100,000	
To Ordinary Share Capital			100,000
being issue of 100,000 Ordinary shares of £1 each at par for the purpose of redeeming Preference shares			
6 per cent Redeemable Preference Share Capital	Dr.	100,000	
Premium on Redemption		10,000	
To Cash			110,000
being redemption of 100,000 6 per cent Redeemable Preference shares of £1 each at 22s. per share			
Profit and Loss Appropriation A/c	Dr.	10,000	
To Premium on Redemption			10,000
being premium on redemption of Preference shares written off to Profit and Loss Appropriation A/c			

Note. No capital duty will be payable in respect of the issue of 100,000 Ordinary shares, as the effect of the whole transaction is to leave the total issued capital unchanged.

Example (b)

If, in similar circumstances to the foregoing, the 100,000 new Ordinary shares had been issued at a premium of 10s. per share, part of this premium could have been used to write off the premium on redemption. The first and third journal entries would then be amended as follows:

		£	£
Cash	Dr.	150,000	
To Ordinary Share Capital			100,000
Premium on Shares			50,000
being issue of 100,000 Ordinary shares of £1 each at 30s. per share for the purpose of redeeming Preference shares			
Premium on Shares	Dr.	10,000	
To Premium on Redemption			10,000
being premium on redemption of Preference shares written off to Premium on Shares A/c			

When shares are redeemed out of profits, there is no new issue of capital to take the place of that which has been redeemed; consequently, the whole of the cash required to carry out the redemption comes from the company's present liquid resources. To comply with the requirement that the redemption must be effected out of profits which would otherwise be available for dividend, it is necessary to withdraw the equivalent amount of profit from the Profit and Loss Appropriation Account itself or from some other account, such as General Reserve (if there is one), which might have been drawn upon for payment of dividends.

The amount so withdrawn, which is equal to the nominal value of the shares redeemed out of profits, is transferred to the credit of a special account which has to be called the Capital Redemption Reserve Fund. This fund, needless to say, is not available for payment of dividends.

If the shares are redeemed at a premium, the premium on redemption also has to be paid out of profits available for dividend, unless there is already a balance on Share Premium Account (arising from some earlier issue of shares) which could be used for the purpose. Assuming that the premium is, in fact, paid out of profits, the total amount to be found out of Profit and Loss Account, General Reserve or other "free" balance is thus equal to the amount required to redeem the Preference shares. It follows that a company which has not in existence a sufficiently large balance of undistributed profits cannot effect a redemption of shares in this way.

Example

A company whose financial position was as disclosed in the following (outline) Balance Sheet decided to redeem out of profits, at a premium of 5 per cent, all the Redeemable Preference shares and to draw upon General Reserve to the extent of £50,000 for that purpose:

		£		£
Authorized and Issued Capital:			Sundry Assets	350,000
100,000 Redeemable Preference shares of £1 each fully paid		100,000	Cash at Bank	150,000
200,000 Ordinary shares of £1 each fully paid		200,000		
		300,000		
	£			
General Reserve	100,000			
Profit and Loss A/c	60,000			
		160,000		
Creditors		40,000		
		£500,000		£500,000

The following journal entries are necessary:

		£	£
Redeemable Preference Share Capital	Dr.	100,000	
Premium on Redemption		5,000	
To Cash			105,000
being redemption of 100,000 Redeemable Preference shares of £1 each at a premium of 5 per cent			
General Reserve	Dr.	50,000	
To Profit and Loss Appropriation A/c			50,000
being transfer from General Reserve for the purpose of redeeming Preference shares out of profits available for dividend			
Profit and Loss Appropriation A/c	Dr.	105,000	
To Premium on Redemption			5,000
Capital Redemption Reserve Fund			100,000
being premium on redemption and transfer to Capital Redemption Reserve Fund, provided out of profits available for dividend			

The position disclosed by the Balance Sheet after giving effect to the redemption will be as follows:

	£	£		£
Authorized Share Capital		300,000	Sundry Assets	350,000
Issued Share Capital:			Cash at Bank	45,000
200,000 Ordinary shares of £1 each fully paid		200,000		
Capital Redemption Reserve Fund		100,000		
		300,000		
General Reserve	50,000			
Profit and Loss A/c	5,000			
		55,000		
Creditors		40,000		
		£395,000		£395,000

REDUCTION OF CAPITAL

The only types of capital reduction which call for attention from the point of view of the accountant are those which involve a reduction in the paid-up capital of a company because either part of the capital, being surplus to the requirements of the company, is to be returned to the shareholders in cash; or part of the capital has been lost, is no longer represented by available assets and therefore is to be written down.

If there is only one class of capital to be considered, the problems in each case are comparatively simple and may be illustrated by the following examples:

Example (*a*)

AB, Ltd., having a share capital of £100,000 in 100,000 shares all issued and fully paid, carried on its business at two branches. It has recently sold one of the branches and has no intention of opening a new one. As a result of the sale the company's bank balance now exceeds £60,000, of which £10,000 is considered a sufficient working balance for the present requirements of the company.

By a special resolution of the company, confirmed by the Court, it is decided to repay to shareholders 10s. per share. The necessary journal entry is as follows:

		£	£
Share Capital	Dr.	50,000	
To Cash			50,000
being repayment of 10s. per share in accordance with capital reduction scheme			

The shares will henceforth be described as "shares of 10s. each, fully paid."

Example (*b*)

The Balance Sheet of XY, Ltd., on December 31 was as follows:

	£			£
Authorized and Issued Share Capital:		Fixed Assets:		
200,000 shares of £1 each fully paid	200,000	Goodwill	£30,000	
		Premises	70,000	
		Plant	50,000	
				150,000
5 per cent Debentures	50,000	Current Assets:		
Current Liabilities	30,000	Stock	40,000	
		Debtors	20,000	
		Cash	10,000	
				70,000
		Profit and Loss A/c Debit Balance		60,000
	£280,000			£280,000

It is considered that the goodwill of the company is valueless and that premises and plant are overvalued by £20,000 and £10,000 respectively. A capital reduction scheme is therefore put forward and approved, under which the sum of 12s. per share is to be written off each £1 share. The sum of £120,000 thus written off the issued capital of the company is to be used to eliminate the debit balance on Profit and Loss Account, to write off goodwill and to reduce the values of premises and plant to the figures stated above. The following journal entries are necessary:

		£	£
Share Capital	Dr.	120,000	
To Capital Reduction A/c			120,000
being 12s. per share written off each of 200,000 issued £1 shares, as per capital reduction scheme			
Capital Reduction A/c	Dr.	120,000	
To Profit and Loss A/c			60,000
Goodwill			30,000
Premises			20,000
Plant			10,000
being writing off and revaluation of assets under capital reduction scheme			

The revised Balance Sheet giving effect to the capital reduction scheme will appear as follows:

	£			£
Authorized and Issued Share Capital:		Fixed Assets:		
200,000 shares of 8s. each fully paid	80,000	Premises	£50,000	
		Plant	40,000	90,000
		Current Assets:		
5 per cent Debentures	50,000	Stock	40,000	
Current Liabilities	30,000	Debtors	20,000	
		Cash	60,000	70,000
	£160,000			£160,000

It would be advisable to pass an ordinary resolution at the same meeting restoring the authorized capital to £200,000, so that the benefit of capital duty paid in the past can be retained.

Where there are two or more classes of share capital to be considered, the formulation of a fair and equitable scheme of capital reduction presents much greater difficulty. The matter is obviously one on which professional advice should be taken; the following are some of the factors that must be considered:

(1) Whether the holders of Preference shares have a preferential right for the return of their capital in the event of the company being wound up.

(2) Whether the Preference shares carry the right to cumulative dividends and, if so, the amount of the arrears of such dividends.

(3) The respective voting rights attaching to the various classes of shares, bearing in mind that a special resolution of the company is necessary to approve any scheme.

(4) Whether there is a reasonable prospect of trading profits being earned in the future and, if so, the rate of dividend that the company may reasonably expect to pay on each class of reduced capital.

(5) That if the Preference shares are reduced in value, without either an increase in their fixed rate of dividend or some right to participate in surplus profits, then the holders of Ordinary shares, who will be entitled to the whole of the surplus profits after payment of the (reduced) Preference dividend, will gain rather than lose by the capital reduction.

If, as is usual, the Preference shareholders are entitled to priority in liquidation, it may appear at first sight that the whole of the Ordinary share capital (as well as part of the Preference share capital) has been lost. Nevertheless, the holders of old Ordinary shares are normally allowed to retain some interest in the reconstituted company, in order to secure their assent to the scheme. In such cases the Preference shares are usually reduced and converted into new Ordinary shares.

Example

If, in the case of XY, Ltd., illustrated in the preceding example, the issued capital had consisted of 100,000 6 per cent Cumulative Preference shares of £1 each and 100,000 £1 Ordinary shares, and the fixed dividend on the Preference shares had not been paid for 10 years, the following scheme might be put forward.

The Preference shares and Ordinary shares to be reduced to 12s. and 4s. each respectively. Each new 12s. Preference share to be converted into three new Ordinary shares of 4s. each. The revised capital structure will then be 400,000 Ordinary shares of 4s. each, fully paid (£80,000), and the first of the journal entries necessary to record the scheme would be amended as follows:

		£	£
Preference Share Capital	Dr.	100,000	
Ordinary (£1) Share Capital		100,000	
To Ordinary (4s.) Capital			80,000
Capital Reduction Account			120,000
being reduction of 100,000 Preference shares of £1 each to 12s. per share and conversion into 3 new Ordinary shares of 4s. each, fully paid; and reduction of 100,000 Ordinary shares of £1 each to 4s. per share as per capital reduction scheme			

It will be noted that in all the foregoing examples the company was solvent in the sense that it had sufficient current assets to meet its current liabilities. If that had not been so, no scheme of capital reduction would, in itself, have restored the finances of the company. In such cases, a reconstruction scheme rather than a capital reduction scheme is required; this usually involves the liquidation of the old company and the formation of a new one to take over the business.

DEBENTURES

Debentures represent indebtedness and must, therefore, always be distinguished carefully from share capital. Nevertheless, so far as the book-keeper is concerned, the issue of debentures is very similar in

practically all respects to the issue of shares. Details of individual debenture holders appear in the register of debenture holders, which is one of the statutory books of the company.

In the financial books, issues of debentures are recorded only in total just as an issue of shares would be. Where there are various classes of debentures, each class must, of course, be recorded separately, just as Preference shares are distinguished from Ordinary shares, and so on. Debentures can be issued at a premium or at a discount; the treatment of the premium or discount in the books is precisely the same as that accorded to a premium or discount on shares. The same similarity of treatment arises where issue expenses, underwriting commissions and brokerages are incurred in connexion with public issues of debentures.

One type of debenture issue raises a point which cannot arise in regard to a share issue. Debentures of a fixed amount may be issued to a bank to secure a fluctuating overdraft on current account. In such cases, the issue of the debentures does not, in itself, give rise to any entries in the financial books. The actual liability of the company to the bank at any time is the amount of the overdraft, which is reflected by a credit balance in the company's Cash (Bank) Book. There is, therefore, nothing to post to a Debenture Account in the ledger to show the nominal value of the debentures, which in these circumstances are sometimes said to have been issued as collateral security.

Debentures issued in these circumstances must not be overlooked by the accountant, for although they do not enter into the system of double-entry book-keeping they must appear, as a note, in every Balance Sheet issued by the company while they are still outstanding. This is so even if, at the date of the Balance Sheet, there was no overdraft, unless the arrangement with the bank has been brought to an end and the debentures have actually been cancelled. It is advisable to open a page in the General Ledger headed "Debentures Issued as Collateral Security," and to make a note, but not an actual entry, of the amount involved.

DEBENTURE INTEREST

A loan secured by a debenture normally carries interest at a fixed rate per annum, the rate and the due dates for payment being set out in the debentures or in the trust deed which goes with them.

From the company's point of view this interest is a contractual obligation which must be met whether or not there are profits out of which it can be paid. (Failure to pay the interest on the due dates will normally give the debenture holders the right to enforce their security by the appointment of a receiver; this is so damaging to the company's credit that every possible step will be taken to avoid it.) For this reason debenture interest should be treated as an expense incurred during the period under review and should ultimately appear as a debit in the Profit and Loss Account for that period; it should not, like a dividend, be treated as an appropriation of profits.

Debenture interest is a payment of the class known for income tax purposes as annual charges. The company is, therefore, obliged to deduct income tax at the standard rate from each instalment of interest paid.

Thus, the amount actually paid to the debenture holders, entered on the credit side of the Cash Book and posted to the debit of Debenture Interest Account, will be the "net" amount of the interest after deduction of tax.

The tax deducted by the company has to be accounted for to the Inland Revenue, either indirectly, by the "adding back" of the debenture interest in the computation of the profits upon which the company will be assessed under Schedule D, or directly, where there are no profits so assessable or other available income, by an assessment under Rule 21.

To show the true position, therefore, the debenture interest is "grossed up" by a transfer from Debenture Interest Account to Income Tax Account equivalent to the tax deducted from the interest. Thus, the amount of debenture interest ultimately written off to Profit and Loss Account is increased to the gross amount (which is what the company contracted to pay as interest on the debentures), while the debit balance on Income Tax Account will be reduced to an amount which is equivalent to tax on the actual profits of the company after paying the interest.

Any interest accrued since the last date of payment must be brought into the Balance Sheet as a liability, so that the Profit and Loss Account reflects the proper interest charge for the period under review. Tax can be deducted from the accrued interest if the company has provided for the full income tax liability that will arise in respect of the year's profits.

Example

I.O.U., Ltd., whose financial year ended on December 31, issued, on April 1, 100,000 4 per cent debentures of £1 each at 21s. each, payable in full on application. Interest is payable half-yearly on September 30 and March 31. On the assumption that the standard rate of income tax for the year in question is 7s. 6d. in the £ and that the amount to be provided for income tax on the company's profits for the year ended December 31 is £10,000, the appropriate entries in the ledger and Cash Book will be as follows:

CASH BOOK (EXTRACTS)

		£			£
April 1	To Debenture Application A/c	105,000	Sept. 30	By Debenture Interest less tax	1,250

4 PER CENT DEBENTURES

					£
			April 1	By Debenture Application A/c	100,000

PREMIUM ON DEBENTURES

					£
			April 1	By Debenture Application A/c	5,000

DEBENTURE INTEREST

		£			£
Sept. 30	To Cash	1,250	Dec. 31	By Profit and Loss A/c	3,000
	Inc. Tax A/c	750			
Dec. 31	Balance c/d	625			
	Inc. Tax A/c	375			
		£3,000			£3,000
			Jan. 1	By Balance b/d	625

INCOME TAX

		£			£
Dec. 31	To Balance c/d	10,000	Sept. 30	By Debenture Interest A/c	750
			Dec. 31	" "	375
				Profit and Loss Appropriation A/c	8,875
		£10,000			£10,000

If debentures are issued as collateral security for a bank overdraft, interest will not be paid upon the debentures as such. The overdraft will be subject to interest at an agreed rate calculated on the actual balance due to the bank from day to day. This being bank interest, it is paid without deduction of tax, is debited to a Bank Interest Account in the ledger and shown in the Profit and Loss Account as such. As no tax is deducted there is no question of any transfer to Income Tax Account to "gross up" the payments.

REDEMPTION OF DEBENTURES

The Companies Act does not impose any restriction upon the redemption of debentures. A debenture is a form of indebtedness—not of share capital—and it is clearly desirable that a company should have the utmost freedom to discharge its liabilities. As debentures are normally secured by a charge on the company's assets, their repayment releases the charge and thus tends to improve the position of unsecured creditors.

From the point of view of the company's own financial position, the redemption of debentures does involve considerations which are similar in principle to those recognized in the conditions attaching to the redemption of Redeemable Preference shares. The money required to repay the debenture holders can normally be found in one of two ways:

(1) By making a fresh issue of debentures or even of share capital to provide the required amount.

(2) By drawing upon the present liquid resources of the company, which represent the accumulation of undistributed profits, or the proceeds of sale of an asset which is not to be replaced.

If it is the intention of the company to redeem the debentures at some fixed future date and it is not desired to make a further issue of debentures or share capital for that purpose, profits are sometimes set aside by annual allocations to a sinking fund. This is invested (as in the case of a depreciation sinking fund) either in gilt-edged securities or in a Sinking Fund Policy taken out with an assurance company. The sinking fund method of redemption has two main advantages:

(1) Profits are set aside by regular annual instalments, so that the company is not faced with a sudden demand upon its ordinary resources for repayment.

(2) If, as is usual, the sinking fund is invested in the names of the trustees for the debenture holders, the latter are assured of the company's ability to redeem the debentures at the date agreed upon when they were issued.

The calculation of the sinking fund and the book-keeping entries necessary while it is being built up will be similar to those already considered in regard to depreciation sinking funds, *except* that the annual allocation to the fund is an appropriation of profits and not an expense incurred in earning those profits. It will therefore be written off annually to the Appropriation Account, after the net profit for the year has been ascertained.

When the redemption date arrives and the fund matures, the sale of the investments (or the proceeds of the policy, if the assurance company method is preferred) will produce the cash necessary to pay off the debenture holders (subject to any profit or loss on redemption). There will then still be a credit balance remaining on the Sinking Fund Account, representing the profits which have been set aside for the purpose of the redemption; this balance should be transferred to General Reserve.

Example

I.O.U., Ltd., when it issued the 100,000 4 per cent debentures, agreed to redeem them at par in 20 years' time and for that purpose to take out a Sinking Fund Policy with the Prudent Assurance Company at an annual premium of £3,612 10s.

The entries in the books necessary to record the payment of the annual premiums and the building up of the sinking fund are illustrated by the following journal entries:

Sinking Fund Policy Account Dr.	3,612 10 0	
To Cash		3,612 10
being payment of annual premium. (*Note.* In practice this would not be recorded in the journal, but would be posted from the Cash Book to the ledger.)		

Profit and Loss Appropriation A/c Dr.	3,612 10 0	
To Debenture Sinking Fund A/c		3,612 10 0
being appropriation of profits to meet the annual premium on the Sinking Fund Policy.		

If this method is followed each year, the Sinking Fund Policy will stand in the books at cost (that is, the total of the premiums actually paid). At maturity of the policy in 20 years, its cost will amount to £72,250 and the difference between this sum and the £100,000 received from the assurance company represents interest allowed on the premiums paid. The closing entries in the ledger will then be as follows:

4 PER CENT DEBENTURES

		£			£
Mar. 31	To Cash (redemption at par)	100,000	Jan. 1	By Balance b/f	100,000

SINKING FUND POLICY

		£			£
Jan. 1	To Balance b/f	72,250	Mar. 31	By Cash	100,000
	Debenture Sinking Fund A/c	27,750			
		£100,000			£100,000

DEBENTURE SINKING FUND

		£			£
Mar. 31	To Transfer to General Reserve		Jan. 1	By Balance b/f	72,250
		100,000	Mar. 31	Sinking Fund Policy A/c	27,750
		£100,000			£100,000

As an alternative to recording the policy at cost, it can be adjusted to surrender value each year by a suitable transfer from the Policy Account to the Sinking Fund Account. In the early years the surrender value will be less than cost; in the later years it will probably exceed it. The final result is the same, as whatever balance is brought forward on the Sinking Fund Account at the beginning of the last year, the amount finally transferred to General Reserve must be the £100,000 received under the policy.

When the sinking fund method is used, the balance on Debenture ccount remains unaltered throughout the life of the debentures and the nual charge for debenture interest is constant. An alternative method edemption, which makes it unnecessary to accumulate a sinking fund nevertheless spreads the redemption over a period of years, is to

issue the debentures subject to the condition that a certain number of them will be redeemed by annual drawings. The numbers of the debentures to be redeemed in this way are chosen by ballot.

The accountant should recognize that the amounts paid out in this way represent an appropriation of part of the profits of the company. The Appropriation Account should, therefore, be debited with the amount of the annual instalment, which on the credit side is carried to a Debenture Redemption Reserve. When all the debentures have been redeemed, the latter can be transferred to General Reserve.

DIVIDENDS

The participation of the shareholders in the profits of a company normally takes the form of dividends on their share capital. These dividends may be compared, in some respects, with the drawings of a sole trader or partner. However, whereas the drawings of traders are not limited (except, in the case of partners, by agreement between themselves) and may sometimes encroach on their capital, the dividends that may be paid to shareholders are strictly limited in various ways. For example:

(1) Although dividends are normally declared by the shareholders themselves, they have first to be recommended by the directors. In theory, the members can (but rarely, if ever, do) reduce the dividend below the amount recommended, but they have not the power to increase it. The directors, in recommending a dividend, normally have regard to the financial position of the company and the wisdom of building up reserves (that is, retaining profits within the business). It is, therefore, most unusual for the whole of the profits available to be distributed in dividend.

(2) Even if the directors wish to make the dividend as large as possible, they, and the company, are bound by the legal consideration of "divisible profits." Unless a company makes profits it cannot pay dividends at all, for to do so would amount to returning part of the shareholders' capital. Capital can be returned to shareholders only in the special circumstances that apply to Redeemable Preference shares or under a capital-reduction scheme approved by the Court or, finally, on liquidation of the company. The question "what are divisible profits?" is an important one and is considered later.

(3) In many cases the rights of the holders of a particular class of share capital are limited by the terms of issue of that capital. Thus, Preference shares normally carry the right to receive a fixed dividend out of such profits as may be available; unless they are Participating Preference shares they have no right to any further distribution of profit once their fixed dividend has been paid. The participating rights, when present at all, are usually strictly limited.

There is normally only one class of share capital in any company which has (subject to the availability of profits, the recommendation of the directors and the satisfaction of the prior claims of Preference and other shareholders) an unrestricted right to dividends. Such shares are frequently referred to as the "equity" shares in that particular company.

(4) The incidence of taxation may tend to restrict the payment of dividends; for example, differential rates of profits tax in regard to distributed and undistributed profits and the liability of individual shareholders to pay sur-tax on dividends received from their companies, over and above the full rate of income tax and profits tax already paid by the company. Where private companies are concerned and all (or most) of the shares are held by the directors, there is also a tendency to distribute profits in the form of additional directors' fees (which are assessable as earned income) rather than as dividends (which rank as unearned income).

DIVISIBLE PROFITS

Neither the Companies Act, 1948, nor any of its predecessors attempted to define the expression "divisible profits." It has, therefore, been left for the Courts, in various cases brought before them, to decide the legality of dividends paid in certain circumstances. These cases have generally arisen in regard to companies in liquidation, with the object of obtaining from the former directors (and sometimes the auditors also) damages for misapplying the funds of the company by paying dividends out of capital.

Each case has, of course, been decided by reference to its own particular circumstances, but together they constitute a body of case law from which important general principles are derived. These may be summarized as follows:

(1) The provisions of the company's own Memorandum and Articles must always be considered. They may have the effect of restricting the field of profits out of which dividends may be paid but cannot enlarge it. For example, the Articles might say that dividends are not to be paid out of any capital profit, but only out of ordinary revenue. Such an Article would be valid and in the case of that company no capital profit could be available for distribution except in liquidation. On the other hand, an Article which said that an unrealized capital profit could be carried to Profit and Loss Account and distributed in dividends would be of no effect, for the Courts have laid down strict conditions which severely limit the distribution of capital profits.

Table A, which, in this respect at least, is adopted by most companies, says: "116. No dividend shall be paid otherwise than out of profits."

This merely repeats the general rule, since it is another way of saying that no dividend shall be paid out of capital. It can be said, therefore, that a company which adopts Table A, or has a similar Article of its own, is not subject to any special restriction in regard to the availability of profits for dividend.

(2) Subject to special rules in regard to depreciation, profits other than capital profits are determined by ordinary commercial principles. In one of the earlier cases, that of *The Spanish Prospecting Co., Ltd.*, it was held that profit could be measured by the growth of the net assets of the company at the end of the year, as compared with their

corresponding value at the beginning of the year. This rough and ready single-entry method of calculation is not now likely to find favour, save in the simplest cases.

(3) It is not always necessary to provide for depreciation of fixed assets. This principle was laid down in a series of cases, commencing with *Lee* v. *Neuchatel Asphalte Co., Ltd.* (1889), which dealt mainly with mining companies. In such cases the shareholders are aware that their capital has been sunk in a wasting asset; if no provision is made for depletion (depreciation) of the mine the dividends paid will eventually exhaust the capital as well as the profits of the company.

This might be thought to infringe the fundamental rule against return of capital, but an apparent inconsistency is avoided by the legal conception of capital and profits, as shown by the judgment in the *Neuchatel* case, of which the following extract may be quoted: "If a company is formed to acquire or work property of a wasting nature, e.g., a mine, quarry or patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it may be divided amongst the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished."

Until the Income Tax Act, 1945, came into force the taxation laws did not permit any deduction for depreciation (except to a limited extent in regard to machinery and plant) and in this respect they followed the legal conception of profits.

The same principle has been applied by the Courts in regard to Investment Trust Companies (that is, companies which hold investments for the sake of the interest and dividends receivable thereon, as distinct from Finance Companies, which make profits by dealing in investments). In such cases depreciation of the investments which are held as fixed assets can usually be measured by reference to Stock Exchange quotations; on the other hand, such investments are not necessarily wasting assets and depreciation suffered one year may be made good by a subsequent increase in Stock Exchange values.

It was held in *Verner* v. *General and Commercial Investment Trust, Ltd.* (1894), that a current excess of income over expenditure could be applied in paying dividends even though a serious loss of capital (part at least of which appeared to be irrecoverable) had been suffered through a fall in the market value of the company's investments. It was said in the course of the judgment that "there is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, and in dividing the money annually yielded by it, without preserving the capital sunk so as to be able to reproduce it intact, either before or after the winding-up of the company."

Also: "Such a proceeding may sometimes be very imprudent, but

a proceeding may be perfectly legal and may yet be opposed to sound commercial principles."

These old cases are sometimes quoted as authority for a general rule that no depreciation of fixed assets need be allowed for, subject to the following provisos:

(*a*) That there is nothing in the company's own Memorandum or Articles requiring such provision to be made, either by the setting up of a sinking fund, or otherwise.

(*b*) That the company retains sufficient current assets to meet its current liabilities.

(*c*) That the shareholders are made aware of the position.

There is certainly nothing in the Companies Act which makes any provisions for depreciation of *fixed assets* obligatory; nevertheless, the provisions of the 8th Schedule quoted hereafter seem to imply that such provision will be made. One thing is quite clear: although the law may not compel companies to provide for depreciation, it certainly does not prohibit their doing so.

(4) Whatever the position may be in regard to fixed assets, it is always necessary to provide for depreciation of floating, or current, assets before paying dividends. For example, stocks of materials, work-in-progress and finished goods must not be brought into the accounts at cost (which would be normal) if their realizable value is less than cost. Full provision must be made for bad debts, and doubtful debts must not be brought in at more than they are expected to realize.

Another passage from the judgment in the *Verner* case stresses this important distinction between fixed and floating assets: "Perhaps the shortest way of expressing the distinction which I am endeavouring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided, but that floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case, to divide such excess without deducting the capital which forms part of it, will be contrary to law."

(5) The normal trading profit of a company arises from the sale of its current assets such as stock-in-trade. Sometimes exceptional circumstances may lead to the sale of a fixed asset at a price in excess of that at which it stands in the books. The Courts have held that such a profit, which is in fact a capital profit, may be used for payment of dividends in the following circumstances:

(*a*) The Articles must not prohibit it. This point has been considered already.

(*b*) The profit must have been realized. A mere appreciation in value of a fixed asset (for example, where the market value of the investments of an Investment Trust Company has increased) can never be available for distribution because such a revaluation does not, in itself, provide any liquid resources which could be used for payment of the dividend.

(*c*) All assets belonging to the company must be revalued and the capital profit must be used in the first instance to make good any

depreciation of other assets (fixed or floating) that has not already been provided for out of trading profits.

(6) If a company incurs a large trading loss or a series of losses which exceed the amount of any undistributed profits brought forward, the result will be a debit balance on Profit and Loss Account. This implies that, for the time being at least, part of the shareholders' capital has been lost. At this juncture it is, of course, impossible for the company to pay any dividends. If, however, profits are earned subsequently the question arises whether the debit balance on Profit and Loss Account must be made good out of such profits before any dividends are paid.

Obviously, the most prudent course is to make good the debit balance before paying any dividends. This may bear hardly on some of the shareholders, however, particularly if part of the capital is in the form of Non-Cumulative Preference shares. Various decisions of the Courts which are a logical sequel to those dealing with depreciation of fixed assets (that is, wastage of capital) seem to indicate that, subject to the Articles, it is not necessary to make good the debit balance before paying dividends out of current profits.

Sometimes the difficulty can be overcome by writing back to Profit and Loss Account depreciation which in the past has been, but need not have been, written off fixed assets such as goodwill. In this way the debit balance is eliminated and there is then no doubt at all about the availability of the current profits. This procedure was approved by the Court in *Stapley* v. *Read Bros., Ltd.* (1924).

INCOME TAX DEDUCTION

Dividends paid or payable by a company are not allowed as a deduction from its profits before those profits are assessed to income tax and other taxes. Only the balance remaining after providing for taxes is then available for payment of dividends; to the extent that dividends are paid, however, the company may recoup tax by deduction from the dividends. The Income Tax Act, 1918 (General Rule 20), provides:

"The profits or gains to be charged on any body of persons shall be computed in accordance with the provisions of this Act on the full amount of the same before any dividend thereof is made in respect of any share, right or title thereto, and the body of persons paying such dividend shall be entitled to deduct the tax appropriate thereto."

The rate of tax to be deducted is the standard rate in force at the time when the dividend is payable; this is not necessarily the rate at which the profits themselves have been or will be assessed.

It will be observed that while a company is entitled to deduct tax from dividends, it is not obliged to do so as it is where debenture interest or other annual charges are paid. Dividends may therefore be paid "free of tax" on shares of which the dividend rights are not limited.

The shareholder who receives a "free of tax" dividend, is, however, deemed to have received the equivalent (larger) dividend "less tax" and when he completes his own income tax return it is this "gross equivalent" that must be entered.

Example

A company with the following share capital, all issued and fully paid-up:

100,000 6 per cent Cumulative Preference shares of £1 each
50,000 £1 Ordinary shares

has a balance of £15,000 as profit available for distribution, after providing for income tax (and any other taxes on profits, such as profits tax) on its profits to date. The standard rate of income tax is assumed to be 7s. 6d. in the £.

The 6 per cent Preference dividend for the year requires gross 6 per cent on £100,000	=	£6,000
Less Income Tax at 7s. 6d.		2,250
Net amount payable to Preference shareholders		£3,750

It would not be permissible to pay this dividend free of tax unless the shares were issued as 6 per cent "free of tax" Preference shares, when it would, of course, be obligatory to do so. To do so without this instruction in the terms of issue would be giving the Preference shareholders more than they had contracted for and would be depriving the Ordinary shareholders of part of the balance of profit which should be available for their dividend.

After payment of the Preference dividend the remaining balance of profit will be £15,000 less £3,750 = £11,250. This is equivalent to $22\frac{1}{2}$ per cent on the Ordinary Share Capital of £50,000 and as income tax on the profits has already been provided for it would appear that the company could pay a dividend of $22\frac{1}{2}$ per cent "free of tax." It is, however, most unlikely (and generally would be most imprudent) that the whole of the available profit will be distributed in this way. Some part of it may be carried to Reserve, used to write off Preliminary Expenses or applied in various other ways, and it is usual to leave some balance to be carried forward to the next year. If, therefore, it is decided to pay out £5,000 in dividend to the Ordinary shareholders, this can be expressed either

(*a*) as a dividend of 10 per cent "free of tax" on £50,000	=	£5,000
or		
(*b*) as a dividend of 16 per cent less tax on £50,000	=	£8,000
Less Tax at 7s. 6d.		3,000
		£5,000

The amount payable to the shareholders is the same in each case, namely, £5,000, which in each case is equivalent to a "gross" of £8,000.

To the accountant, therefore, it is immaterial whether a dividend is declared "free of tax" or "less tax"—the one is merely an alternative way of expressing the other; it is the total *net* amount actually payable

to the shareholders, or to that class of shareholders, that really matters. Dividends are appropriations of profit made after taxation on the profits has been provided for; they are therefore transferred "net" to the debit of Profit and Loss Appropriation Account and the "grossing up" procedure already explained in relation to debenture interest, has no application to dividends.

DIVIDEND BANK ACCOUNTS

Companies with a large number of shareholders usually open a special bank account (for example, Dividend (No. 10) Account; 6 per cent Preference Dividend (No. 15) Account, and so on) for every dividend that is declared. The account is opened by transferring from the general bank account the exact amount required to pay the dividend either after deduction of tax or tax-free as the case may be. The cheques or warrants drawn in favour of individual shareholders are then cleared by the bank against the dividend account, which will thus be closed automatically as soon as the last cheque has been presented. The treatment of unclaimed dividends is considered later.

DIVIDEND WARRANTS

If special dividend bank accounts are opened, dividend warrants are usually printed specially for each dividend. Part of each warrant is in the form of a cheque, is detachable from the other part and is cleared by the shareholder's bankers, as though it were an ordinary cheque. The other part of the warrant (known as the top or counterpart), which is retained by the shareholder, contains a statement showing how the gross dividend is calculated, the amount of tax deducted and the net amount payable. Even if the dividend has been declared "free of tax" the equivalent gross amount (and the tax which is deemed to have been deducted from it) must be shown, so that the shareholder can complete his own income tax return correctly.

A shareholder who is not liable to pay tax at the full standard rate can produce the counterfoil to his Inspector of Taxes and claim repayment of either the whole or part of the tax deducted, according to his total income from all sources and other factors which enter into the calculation of his personal income tax liability. To enable the counterfoil to be used in this way, it contains the words: "I hereby certify that Income Tax on the profits of this Company, of which this dividend forms a part, has been or will be paid by the Company to the proper Officer for the receipt of taxes."

It follows, therefore, that where a distribution is made to shareholders out of profits that are not taxable in the hands of the company (for example, out of a realized capital profit) the certificate required by the Income Tax Acts cannot be given. Such distributions are thus made without deduction of tax, the amount distributed is not liable to be "grossed up" and is not income that has to be entered in the personal returns of the shareholders. Consequently, a shareholder is unable to obtain any repayment of tax in respect of such a distribution, but, on the other hand, he will not be liable to sur-tax in respect of it, even though

his other income is high enough to attract that impost. In such cases the counterfoil of the dividend warrant will be suitably worded to show that the distribution is being made out of a non-taxable source.

Private companies or public companies with only a small membership do not normally have dividend warrants specially printed, nor do they open special bank accounts for each dividend. Dividends are then paid by an ordinary cheque drawn on the company's general bank account. Each cheque must, however, be accompanied by a statement which includes all the information required for income tax purposes; this can either be written out on the company's notepaper, or blank printed forms may be used, of which the following is a specimen:

....

LIMITED.

Notice of Dividend for the year to....................19

No............ ....

...................., 19

$\frac{\text{An Interim}}{\text{A Final}}$ Dividend at the rate of............per cent per annum on the amount paid up on the......................Shares of the company having been declared for the year to....................19 , a cheque is enclosed herewith for the amount to which you are entitled, as follows:—

	Dividend at..........per cent per annum on..........Shares of £......each, ...paid up	£	:
I hereby certify that Income Tax on the profits of the company, of which profits this dividend forms a portion, has been, or will be, duly paid to the proper officer for the receipt of Taxes.	*Less* Income Tax at......in the £ ..	£	
	Net Amount of Dividend	£	: :

To.................................. ....*Secretary.*

N.B.—This Notice should be preserved, as it will be accepted by the Inland Revenue Authorities in connexion with any claim to allowance or relief from Income Tax.

DIVIDEND ACCOUNTS

Dividends, like the share capital on which they are said to be paid, are recorded in a company's books of account in total. A detailed list, showing the name and address of each shareholder, the number of shares in respect of which he is entitled to dividend, the gross amount, the income tax deduction and the net amount actually payable must, of course, be prepared before the warrants can be completed. This Dividend List, however, is not part of the double-entry book-keeping system. It can be regarded as a schedule or voucher, showing how the total dividend is made up.

As dividends are ultimately transferred "net" or "less tax" to the debit of Profit and Loss Appropriation Account, the only significant amount that has to be recorded in the ledger, pending the preparation of the annual accounts, is the net amount actually paid out. If a separate banking account is used, this net amount will be the actual transfer from the general bank account to the dividend bank account; this appears as a

single item on the credit side of the Cash Book and it only remains to post it to the debit of Dividends Payable Account.

Where ordinary cheques are drawn to pay a dividend, the name of each shareholder and the amount paid to him will of necessity appear in the Cash Book (if this is not done difficulty will be experienced in reconciling the Cash Book and Bank Statement). By suitable use of one of the inner details columns of the Cash Book, however, it is still possible to show the total payment and to post that total to the ledger.

Separate Dividend Payable Accounts should be opened for each class of share capital, or the columnar form can sometimes be used. It is not necessary to open a new account every time a further dividend is declared, however.

Example

XY, Ltd., has an issued share capital of £250,000, in 100,000 6 per cent Cumulative Preference shares of £1 each and 150,000 £1 Ordinary shares. During the year ended September 30 it actually paid the following dividends: On the Preference shares, 3 per cent less tax on March 31 and September 30, making together the full dividend for the year.

On the Ordinary shares, an interim dividend of 10 per cent "free of tax" on June 30.

The standard rate of income tax was 8s. in the £ up to April 5 and 7s. 6d. *in* the £ thereafter.

The debit side of the Dividends Payable Account, before the books are closed on September 30, will appear as follows:

Dr.

			Preference	Ordinary
			£	£
March 1	To Cash:			
	3% on £100,000 =	£3,000		
	Less Tax @ 8s. 0d. =	1,200		
			1,800	
June 30	To Cash			
	10% free of tax on £150,000			15,000
Sept. 30	To Cash			
	3% on £100,000 =	3,000		
	Less Tax @ 7s. 6d. =	1,125		
			1,875	

The account will be closed by transferring each of the debit totals to the debit of Profit and Loss Appropriation Account, but before that is done provision must be made for any further dividends payable in respect of the year ended September 30.

DIVIDENDS PAYABLE

To comply with the Companies Act, 1948, which provides: (1) in regard to the Profit and Loss Account (8th Schedule, 12 (1)) "There shall be shown—.........(*h*) the aggregate amount of the dividends paid

and proposed" and (2) in regard to the Balance Sheet (8th Schedule, 8 (1)) "There shall be shown under separate headings..........(*e*) the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend," it is necessary to bring into account any further dividends that will be payable in respect of the year under review.

Strictly, a dividend is not a liability (in the sense that a shareholder could sue the company for it) until it is declared. Further, while the directors may pay interim dividends (including fixed dividends payable at regular dates on Preference shares, according to their terms of issue), they may only recommend a final dividend, which is then declared by the shareholders at the annual general meeting of the company. Nevertheless, it is clearly desirable that in the Profit and Loss Account the debit for dividends should be related to the profit for the year (or other period) out of which they are in fact to be paid, and in the Balance Sheet the amount by which the payment of the final dividends will deplete the liquid resources of the company should be shown. Both these results are secured by the provisions of the Companies Act quoted above.

In the ledger the dividend payable can conveniently be carried down as a credit balance on Dividends Payable Account.

Example

AB, Ltd., a private company, with an issued and fully paid share capital of £10,000, paid an interim dividend of 4 per cent less tax on April 30 in respect of the year ending September 30. The directors recommended a final dividend of 6 per cent less tax, which was approved by the shareholders and paid on November 30. The standard rate of income tax was 8s. in the £.

The Dividends Payable Account will appear as follows:

			£			£
April 30	To Cash: 4% on £10,000 = £400 *Less* Tax @ 8s. 160		240	Sept. 30	By Profit and Loss Appropriation A/c	600
Sept. 30	To Balance: 6% on £10,000 = 600 *Less* Tax @ 8s. 240		360			
			£600			£600
Nov. 30	To Cash		360	Oct. 1	By Balance b/d	360

UNCLAIMED DIVIDENDS

When a special bank account is opened for payment of a dividend, the existence of unclaimed dividends will be revealed by the fact that the Dividend Bank Account does not clear itself in a reasonable time. On checking over the bank statement (or clearing lists) with the Dividend

Schedule from which the warrants were prepared, it will be possible to extract a list of uncleared warrants.

Many of these will be known to the company already, for most unclaimed dividends originate in the failure of shareholders to notify their changes of address; the warrants then come back from the Post Office undelivered. Dividends may also remain unclaimed for some time following the death of a shareholder, as until the persons entitled have taken out probate or letters of administration (and registered them with the company) the warrants drawn in favour of a deceased shareholder cannot be encashed.

At least once a year entries must be made in the company's books to enable such unclaimed dividends to appear in the Balance Sheet as a liability. While the special bank accounts remain open this liability will, of course, be counterbalanced by a corresponding balance at the bank, which is additional to the bank balance as shown by its Cash Book.

As dividends may remain unclaimed for many years and some may never be claimed, it is not usually considered desirable to keep open a large number of separate bank accounts. An Unclaimed Dividends Account is then opened at the bank, to which any balance remaining on a separate dividend account is transferred after, say, six months.

The unclaimed dividends are brought into the double-entry bookkeeping system by a journal entry debiting Unclaimed Dividends Bank Account and crediting Unclaimed Dividends Account. Reverse entries will record the payment of such of these amounts as may ultimately be claimed by the shareholders concerned.

DIVIDENDS ON PARTLY PAID SHARES

When dividends are payable in respect of shares which have not yet become fully paid or on which calls fell due during the period in respect of which the dividend is payable, the rights of the various shareholders will depend on the provisions of the company's Articles or on the terms upon which the shares were issued. In the absence of any provision it would appear that dividends are payable on the nominal value of the shares. This is clearly inequitable where different shareholders have paid up different proportions of the nominal value of their holdings, and Section 59 of the Companies Act, 1948, which is as follows:

"A company, if so authorized by its articles, may do any one or more of the following things:

(*a*) make arrangements on the issue of shares for a difference between the shareholders in the amounts and times of payment of calls on their shares;

(*b*) accept from any member the whole or a part of the amount remaining unpaid on any shares held by him, although no part of that amount has been called up;

(*c*) pay dividend in proportion to the amount paid up on each share where a larger amount is paid up on some shares than on others."

obviously contemplates that some provision will be made in the Articles. In Table A this provision is found in Clause 118, which is as follows: "Subject to the rights of persons, if any, entitled to shares with special

rights as to dividend, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend is paid, but no amount paid or credited as paid on a share in advance of calls shall be treated for the purposes of this regulation as paid on the share. All dividends shall be apportioned and paid proportionately to the amounts paid or credited as paid on the shares during any portion or portions of the period in respect of which the dividend is paid; but if any share is issued on terms providing that it shall rank for dividend as from a particular date such share shall rank for dividend accordingly."

Calls paid in advance are excluded from dividend until such time as they become due for payment, because Table A (Clause 21) also provides that interest at a rate not exceeding 5 per cent per annum (or such higher rate as may be agreed by the company in general meeting) may be paid in respect of calls received in advance of the due dates; clearly it would be unreasonable to pay interest and dividend on the same amount.

On the other hand, Table A (Clause 18) also provides that interest at a rate not exceeding 5 per cent per annum may be charged on calls in arrear; such arrears are still excluded from dividend, however, by Clause 118 and there is thus a double penalty on a shareholder who delays payment of his calls. In practice it is unusual to charge interest on calls unless they have been in arrear for a substantial time. It is customary where a new issue is made to provide that all the shares comprised in it shall rank for dividend as from a particular date.

BONUSES

A bonus to shareholders payable in cash is merely an additional dividend and is recorded as such. The reason for declaring part of the distribution as a bonus is usually that an exceptional and, perhaps, non-recurring profit has been made. If the whole amount were declared as a dividend, shareholders might be misled as to the probable future trend of dividends on their shares. As the matter is one of description rather than principle, the entries in the books will be the same as for the payment of an ordinary dividend.

The term bonus is also applied to the issue to shareholders of additional shares in proportion to their existing holdings, these additional or bonus shares being credited as fully or partly paid up. A share bonus absorbs profits in the same way as a cash bonus or dividend and is thus reflected by a debit entry in the Profit and Loss Appropriation Account (or, sometimes, by a debit in General Reserve Account, if profits previously transferred to Reserve are used for the purpose); on the credit side, however, an entry in Share Capital Account takes the place of a credit in the Cash Book.

The Capital Redemption Reserve Fund created when Redeemable Preference shares are redeemed out of profits may be "applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares."

Often a substantial part of a company's profits is used to acquire additional fixed assets. This money is obviously not still available for

dividends or cash bonuses. The distribution of a share bonus brings the issued capital into line with the assets actually employed in earning future profits and withdraws from the Profit and Loss Appropriation Account (or General Reserve) past profits that are no longer available.

A shareholder who would prefer to have cash rather than an additional shareholding can usually sell his rights. If he does so, however, he is realizing part of his capital, for his holding in future will represent a smaller fraction of the total capital of the company than it did before. Bonus issues do, in fact, have the effect of diluting the company's issued capital, and although there is usually ample justification for them at the time when they are made, a change in the fortunes of the company may sometimes lead to regrets at a later date.

Shares issued as bonus shares may be of any class which the company has power to issue (for example, Preference shares could be issued as bonus shares to the holders of Ordinary shares), always provided that there are profits or reserves available for the purpose. On the other hand, they can only be issued to those shareholders whose shares entitle them to the balance of profits remaining after payment of preferential dividends. Dividends on Preference shares are payable in cash and, having been so paid, the holders have no further rights either to dividends or bonuses.

The journal entries necessary to give effect to a bonus issue of shares are illustrated in the following example:

Example

A company has an issued share capital of 100,000 £1 6 per cent Preference shares and 100,000 £1 Ordinary shares. Some years previously it had redeemed 50,000 Preference shares out of profits and thus had £50,000 standing to the credit of Capital Redemption Reserve Fund. It also has a General Reserve amounting to £30,000 and a balance of £35,000 on Profit and Loss Account. It resolves to make a bonus issue of one new £1 Ordinary share for every existing Ordinary share, utilizing for that purpose the balances on Capital Redemption Reserve Fund and General Reserve and drawing upon the Profit and Loss Account for the remainder. The necessary resolution was passed and the bonus shares were allotted on March 31.

The requisite journal entry is as follows:

			£	£
March 31	Capital Redemption Reserve Fund	Dr.	50,000	
	General Reserve		30,000	
	Profit and Loss Appropriation A/c		20,000	
	To Bonus A/c			100,000
	being application of undistributed profits in payment of a share bonus of 1 Ordinary share of £1 for every existing £1 Ordinary share.			
March 31	Bonus A/c	Dr.	100,000	
	To Ordinary Share Capital			100,000
	being allotment of bonus shares as above.			

DIRECTORS' REMUNERATION

The fees of directors, as such, are fixed either by the company's Articles or they are voted by the company in general meeting. Failing such provision the directors are not entitled to fees. The Articles, however, usually empower the directors:

(1) to appoint one or more of their body to the office of managing director for such period and on such terms as they think fit, and to fix his or their remuneration.

(2) to appoint any director to a salaried office (for example, sales manager) in the company, which he will hold in addition to his directorship.

TAX-FREE REMUNERATION

By Section 189 of the Companies Act, 1948, the payment of tax-free remuneration to a director, whether in his capacity as a director or otherwise, is prohibited except under a contract which was in force on July 18, 1945, and provided expressly for remuneration to be paid free of tax. This prohibition extends to the payment of surtax on a director's behalf, as well as income tax. Remuneration due before July 1, 1948, when the Act came into force, or payable after that date in respect of a period before July 1, 1948, is not affected, even though it arises under a contract of later date than July 18, 1945.

DISCLOSURE IN ACCOUNTS

Full disclosure of directors' remuneration, either in the annual accounts or in a statement annexed thereto, is required so that the shareholders (for whom the directors are, in some respects, trustees) are made aware of the amount so paid. It is not necessary to disclose the amounts payable to individual directors, but the following aggregates must be shown:

(1) *Directors' emoluments*. The expression emoluments is defined as including fees and percentages, any sums paid by way of expenses allowance in so far as these sums are charged to United Kingdom income tax, any contributions paid in respect of directors under any pension scheme and the estimated money value of any other benefits receivable by directors otherwise than in cash.

(2) *Directors' or past directors' pensions*. These need not be included, however, in so far as they arise under a pension scheme the contributions to which are substantially adequate for the maintenance of the scheme (the company's contributions to such a scheme will already have been disclosed under (1) above).

(3) *Compensation to directors or past directors in respect of loss of office*. This includes sums paid as consideration for or in connexion with a director's retirement from office.

As the required totals can be disclosed either in the accounts or in a statement annexed thereto, directors' fees are not included in the requirements of the 8th Schedule as to items which must be disclosed separately in every Profit and Loss Account. Nevertheless, where the only amount that requires to be disclosed is the total of directors' fees,

the requirements of the Act are met most simply by showing this as a separate item on the debit side.

In more complicated cases, and particularly where the value of "benefits received otherwise than in cash" has to be included, it is usually simpler to give the required information in the form of footnotes. This has the advantage of enabling an item such as the salary of a director who is also the works manager to be charged in the proper section of the detailed accounts (in this case in the Manufacturing Account), so that the figure of net trading profit, which is usually the starting point of a published Profit and Loss Account, is correctly computed.

LOANS TO DIRECTORS

Unless a company is an exempt private company it is not lawful for it to make a loan to one of its directors or to enter into any guarantee or provide any security in connexion with a loan made to him by any other person, save only in the exceptional circumstances provided by Section 190. The most important of these exceptions covers loans made in the ordinary course of business by a company whose ordinary business includes the lending of money.

An exempt private company can lend money to one of its directors, if it wishes to, but any such loan will then be subject to the provisions of Section 197 in regard to the disclosure, in the annual accounts of the company, of loans to officers of the company. (By Section 455, the expression officer, in relation to a body corporate, includes a director, manager or secretary.)

Loans made in the ordinary course of business by a company whose ordinary business includes the lending of money are again excepted. So far as officers other than directors are concerned, there is also an exception in favour of any loan not exceeding £2,000 which is certified by the directors to have been made in accordance with any practice adopted or about to be adopted by the company with respect to loans to its employees. (This might arise, for example, under a house-purchase scheme for the benefit of the company's employees.)

Subject to these exceptions, the provisions of Section 197 are as follows:

"The accounts which, in pursuance of this Act, are to be laid before every company in general meeting shall, subject to the provisions of this section, contain particulars showing:

(*a*) the amount of any loans made during the company's financial year to:

(i) any officer of the company; or

(ii) any person who, after the making of the loan, became during that year an officer of the company;

by the company or a subsidiary thereof or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and

(*b*) the amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof."

In so far as loans made by the company itself are still outstanding at the end of the financial year (which is defined as including any period for which a Profit and Loss Account to be laid before the members is made up, whether that period is in fact one year or not) they will, of course, be assets of the company at the date of the Balance Sheet, and the simplest way to comply with the section is to show the necessary totals separately therein. Even so, it may be necessary to give further information either inset or by way of a note.

Example

X, Ltd., an exempt private company, with four directors, A, B, C and D, of whom C was also secretary of the company and D was the managing director, and a works manager E and sales manager F:

(1) Before the beginning of the year had lent £3,000 to A and £2,000 to B, of which the loan to A had been repaid during the year but the loan to B was still outstanding.

(2) During the year lent £1,500 each to C and E under a house-purchase scheme for the benefit of the company's employees, which advances were both outstanding at the end of the year; and lent £2,500 to D and £1,000 to F, not under the house-purchase scheme, of which the loan to D was repaid during the year but the loan to F was still outstanding.

Of the above loans, the following do not have to be included in totals which have to be disclosed to comply with the Act.

(1) The loan to A, since this loan was not made during the year and was not outstanding at the end of the year. (It will, of course, have been included in the totals disclosed in last year's Balance Sheet and will, therefore, be disclosed again, indirectly, in the "comparative figures" required by the 8th Schedule.)

(2) The loan to E under the house-purchase scheme, as this is within the exemption already discussed, E not being a director of the company. (But the loan to C must be included because, although it was made to him in his capacity as secretary, he is also a director of the company.)

The requisite information can, therefore, be given in the Balance Sheet in the following way:

Loans to Officers:

	£	£	£
Loans made during the year	5,000		
Less Repaid during the year	2,500		
		2,500	
Loan made before the commencement of the year and still outstanding		2,000	
			4,500

QUESTIONS AND EXERCISES

(Key to answers on page 571)

(1) Gold Mines of Tooting, Limited, was registered on January 1, with a nominal capital of 500,000 shares of £1 each. An agreement was entered into with Mr. D. Viner for the acquisition from him of a 20 years' lease of half an acre of gold-bearing land, he to receive 100,000 fully paid shares in payment. A prospectus offering 400,000 shares to the public was issued on January 10. These shares were to be payable:

5s. per share on application.	2s. 6d. per share on February 15.
10s. per share on allotment.	2s. 6d. per share on March 31.

The following transactions took place:

Jan. 11 Applications received for 320,000 shares, together with payment in full for a further 10,000 shares—£90,000.
,, 13 330,000 shares allotted to the public.
,, 14 Received on account of allotment moneys—£150,000.
,, 15 Agreement with Viner confirmed. 100,000 shares issued to him as fully paid.
,, 31 Balance of allotment money received.
Feb. 15 2s. 6d. per share called up.
,, 17 Received on account of call—£30,000.

You are required to submit the necessary ledger accounts (journal entries need not be given) and to draft the company's Balance Sheet as at February 28. (*Inst. of Bankers, Part I*).

(2) XY, Limited, was formed with an authorized capital of £100,000, one-half in Ordinary and one-half in 6 per cent Preference shares of £1 each, to acquire on December 31 the business carried on by X, whose Balance Sheet at that date was as follows:

	£		£
X Capital Account	49,000	Freehold Premises	13,000
Sundry Creditors	8,000	Machinery and Plant	15,000
Bank Overdraft	4,000	Stock	11,500
		Sundry Debtors	21,500
	£61,000		£61,000

The purchase price was agreed at £65,000, out of which sum the company undertook to discharge the sundry creditors and bank overdraft; the balance to be paid on March 31, without interest.

30,000 of the Ordinary shares were issued (at a premium of 5s. per share) payable 5s. per share on application and 10s. per share on allotment (including the premium). The whole of the Preference shares were issued at par, payable in full on application. In addition, £10,000 5 per cent debentures, payable in full on application, were issued at a discount of 5 per cent.

You are required to give the journal entries necessary to record the above in the company's books. (*Chartered Accountants, Inter.*).

(3) X, Ltd., prepares accounts annually to June 30. On January 1 the company's issued capital consisted of 200,000 shares, all of which were 10s. called and paid.

On May 4 the directors made a call of 5s. per share. By May 18 this call had been paid by all the company's members with the exception of X, the holder of 1,000 shares. On June 8, after due notice, the directors forfeited X's shares and on the following July 12 re-issued them to Y as 15s. paid at the price of 12s. per share paid in full in cash on that day.

Set out the ledger entries recording the above and also the relative entries that would appear in the company's Balance Sheet drawn up as on June 30. (*L.C. of C. Higher*).

(4) Smith and Jones were trading in partnership, sharing profits and losses in the ratio of 3 to 2 and preparing accounts annually to March 31. As on March 31, 1949, Smith's Capital and Current Accounts together amounted to £19,650 and Jones's to £7,550.

On June 30, 1949, the business was converted into a limited company which took over the whole of the assets and liabilities on that day, issuing in exchange 28,000 fully paid shares of £1 each, of which Smith took 20,000 and Jones 8,000. No Profit and Loss Account was prepared until March 31, 1950, when the following information became available:

		£
Sales, 3 months to 30 June, 1949		12,030
Sales, 9 months to 31 March, 1950		32,080
		£44,110
Gross Profit for the year	£	10,670
Less Directors' Fees (9 months)	2,400	
Formation Expenses written off	100	
Salaries and Wages (other than directors) and other normal trade expenses, all assumed evenly spread over the year	3,600	
		6,100
Balance, net profit for the year		£4,570

During the three months ended June 30, 1949, Smith's drawings had amounted to £900 and Jones's to £600.

You are required to compute: (*a*) The undistributed profit, if any, up to June 30 and say how the company should deal with this in its accounts, and (*b*) What sum, if any, is due from one partner to the other.

(*Chartered Accountants, Inter.*).

(5) A limited company was formed to acquire the business of M, the purchase consideration being agreed at £60,000, to be satisfied by the payment to M of £30,000 in cash and by the issue of 30,000 fully paid shares of £1 each. The purchase money was paid and the shares duly allotted to M on March 1.

The capital of the company was £100,000 in shares of £1 each, of which 50,000 shares had been issued on January 1, payable as to 5s. per share on application, 5s. on allotment on January 10, 5s. on the first call on February 1, and 5s. on the final call on March 1.

The holders of 600 shares failed to pay the first call, while the holder of a further 100 shares failed to pay the final call. In accordance with the Articles of Association, these shares were forfeited on April 1.

The Preliminary Expenses, amounting to £1,000, were paid by the company, on March 1.

You are required to give the Cash Book and journal entries necessary to record the above transactions. (*Chartered Accountants, Inter.*).

(6) B, Ltd., had issued 10,000 6 per cent Redeemable Preference shares of £1 each which were due for redemption on March 31 at a premium of 2s. 6d. per share.

On March 31 the directors decided to use the balance standing to the credit of Reserve Fund £5,000, and £2,000 from the balance to the credit of Profit and Loss Account, for the purpose of redeeming the Preference shares, and to issue £1 Ordinary shares, at a premium of 4s. per share on issue, to provide the balance required.

You are asked to show by means of journal entries how the above transactions should be recorded in the books of B., Ltd. (*C.I.S. Inter.*).

(7) The following was the Balance Sheet of Z, Ltd., as on September 30:

	£		£
Authorized Capital	200,000	Fixed Assets:	
		Goodwill, Patents and Trade Marks	71,000
Issued and fully paid Capital:		Buildings	26,200
75,000 6% Cum. Pref. Shares of £1 each	75,000	Plant and Machinery	38,500
200,000 Ordinary shares of 10s. each	100,000	Furniture and Fittings	3,900
		Current Assets:	
	175,000	Stock-in-Trade	48,900
Capital Reserve	12,250	Sundry Debtors	19,700
4% Debentures	40,000	Cash in hand	100
Sundry Creditors	7,650	Profit and Loss Account	37,200
Bank Overdraft	10,600		
	£245,500		£245,500

It was decided to reduce the capital and the following scheme was agreed to by the shareholders and sanctioned by the Court: the Preference shares were reduced to 15s. each and the Ordinary shares to 1s. each, and the capital reserve was eliminated.

The credit balance of £121,000 so arising was used to write off the debit balance of the Profit and Loss Account and to reduce the fixed assets (which were overstated owing to insufficient provision having been made for losses and depreciation) by the following amounts:

	£
Goodwill, Patents and Trade Marks	66,000
Buildings	1,200
Plant and Machinery	15,500
Furniture and Fittings	1,100
	£83,800

The reduced shares of both classes were consolidated into new Ordinary shares of £1 each fully paid, and, after completion of the scheme, 50,000 newly created 5 per cent Preference shares of £1 each were issued for cash at par in order to provide fresh working capital. 10s. per share was called and paid on these, and the bank overdraft paid off out of the proceeds.

Draw up the Balance Sheet of Z, Ltd., after completion of the above transactions. (*R.S.A. Stage III*).

(8) In 1913 the XYZ Co., Ltd., offered for subscription, at par, £15,000 of 5 per cent debentures, repayable at par on November 30, 1950. Interest was payable half-yearly, on May 31 and November 30. The issue was fully subscribed and all expenses in connexion therewith were written off out of revenue during the first five years of the currency of the issue. By the terms of issue the company agreed to set aside a sum of £488 annually out of profits to form a sinking fund for the redemption of the debenture issue, such sums to be invested in gilt-edged securities, together with any interest arising therefrom. On November 30, 1949, the book value of the investments stood at £12,637 and on December 1, 1949, a further £488 was duly invested. During the year ended November 30, 1950, the net income arising from the sinking fund investments amounted to £577, which was re-invested as received. At the end of the period a further £488 was appropriated, all the sinking fund investments were sold, realizing £14,850, and the debentures were paid.

Prepare the following on November 30, 1950: (1) Debenture Account; (2) Sinking Fund Account; (3) Sinking Fund Investments Account. How would you deal with the balances of the two latter accounts after the above transactions have been recorded? (*Incorporated Accountants, Final*).

(9) On January 1, 1950, XY, Limited, issued £100,000 of debentures at a discount of 6 per cent, repayable at par out of profits by equal annual drawings over a period of 5 years. The drawings were duly made on December 31 in each year and repayment made on the following day.

The discount is to be written off over the period of the debentures in such a way that each year bears a charge that is proportionate to the amount of the debentures outstanding in that year.

Calculate the amount of discount to be written off in each year and show the journal entries required to record the transactions taking place on December 31, 1952. (*Chartered Accountants, Inter.*).

(10) In preparing the final accounts of a company, (*a*) would you charge to Appropriation Account the net amount (after deduction of income tax) or the gross amount of dividends paid; (*b*) would you charge to Profit and Loss Account the net amount (after deduction of income tax) or the gross amount of debenture interest paid? Give reasons for your answer. (*Inst. of Bkprs. Associate*).

(11) R, Ltd., is a public company, its issued capital consisting of 500,000 fully paid Ordinary shares of £1 each. Whenever the company declares a dividend the appropriate amount is transferred to a special banking account, opened for the purpose, out of which the warrants are paid on presentation. After this has been open for six months the balance remaining (if any) is transferred to a general Deposit Account for Dividends Unclaimed, the corresponding balance at the credit of the Dividend Account in question being transferred at the same time to Unclaimed Dividends Account. The company closes its books annually on May 31.

On November 30, 1949, the following balances were standing on the accounts named:

	£	s.	d.
Unclaimed Dividends Account (representing unclaimed warrants in respect of dividends Nos. 1 to 21)	511	16	6
Deposit Account for Dividends Unclaimed	511	16	6
Dividend Account No. 22	73	5	0
Dividend Account No. 22 Bank Account	73	5	0

On January 10, 1950, shareholder K presented the following warrants:

No. 20/501, payable September 15, 1948	12	10	0
No. 21/507, payable May 2, 1949	25	0	0
No. 22/495, payable September 13, 1949	15	0	0

The first two of these were paid in the first place out of the company's ordinary current account, a corresponding transfer from the special deposit account being made at the end of the month.

On April 27, 1950, the company declared Dividend No. 23 of 5 per cent, free of tax, and by the end of May all warrants in respect of this dividend had been presented except those posted to shareholders M, N and P, who held respectively 500, 2,000 and 150 shares.

You are required to set out, for the six months to May 31, 1950, the separate Dividend Accounts (Nos. 22 and 23), the Unclaimed Dividend Account and the three corresponding Bank Accounts, also to show the corresponding entries in the Balance Sheet drawn up as on May 31, 1950. (*R.S.A. Stage III*).

(12) A limited company had a nominal capital of £400,000 in Ordinary shares of £1 each, all of which had been issued but only 12s. 6d. per share had been called up and paid. The company had standing to the credit of the general Reserve Account a sum of £95,000 and to the credit of Profit and Loss Account a sum of £65,000. It was decided to make the shares fully paid by utilizing so much of the Reserve and Profit and Loss Account as might be necessary for the purpose. The company had the necessary powers and passed resolutions accordingly.

Set out the ledger accounts showing the transactions duly completed. (*A.C.C.A. Inter.*)

CHAPTER XIII

COMPANY ACCOUNTS

(2) ANNUAL ACCOUNTS

ALL the provisions of the Companies Act, 1948, dealing with the contents of a company's annual Balance Sheet and Profit and Loss Account (except Sections 196 and 197, which deal with directors' remuneration and loans to officers respectively), are found in the 8th Schedule to the Act. In so far as these provisions deal with specific matters (such as dividends payable) they have been or will be considered under the appropriate headings. There are, however, certain general principles to be observed in regard to the treatment of assets and liabilities in general, the distinction between reserves and provisions, and so on. The purport of these general rules is indicated below (references are to the numbered paragraphs of the 8th Schedule).

FIXED AND CURRENT ASSETS

The Balance Sheet must contain "such particulars as are necessary to disclose the general nature of the assets and liabilities"(2).

Also, "4 (1) The . . . fixed and current assets shall be classified under headings appropriate to the company's business: Provided that (*a*) where the amount of any class is not material it may be included under the same heading as some other class; and (*b*) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.

"(2) Fixed assets shall also be distinguished from current assets.

"(3) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated."

The terms fixed asset and current asset are not defined and are therefore interpreted according to normal usage. No attempt is made to lay down a set form of Balance Sheet; that, clearly, would be impossible in view of the almost unlimited number of different kinds of business carried on by companies. A certain amount of discretion is, therefore, possible in regard to the amount of detail to be given; one company, for example, might reveal separate figures for stocks of raw materials and of finished goods respectively, and for work-in-progress, while another company might merge these three items into one. The information given must nevertheless be "appropriate to the company's business" and the fundamental rule that fixed and current assets must always be separated from each other applies.

The latter rule was first introduced into company accounting by the Companies Act, 1929; previously the Acts contained no references at all to the contents of a company's annual accounts. Balance Sheets were sometimes published in which practically all the assets were grouped under one description, including such diverse items as goodwill, freehold

and leasehold property, fixed and movable plant and stock-in-trade!

In addition to the general rule requiring fixed assets to be shown separately from current assets, there are many specific provisions in the Act requiring certain kinds of assets, when they exist, to be shown separately. These have been or will be considered under the appropriate headings, namely, Goodwill, Patents and Trademarks, Preliminary Expenses and similar items, Investments, Loans to Officers, and Subsidiary Companies.

DEPRECIATION

To comply with the 1929 Act it was necessary to state "how the values of the fixed assets have been arrived at." Fixed assets were normally recorded either at "cost" or at "cost less depreciation," and such bare words of description were sufficient to comply with the Act. Thus, an item "Plant and Machinery at cost less depreciation, £40,000" might equally well represent plant which had cost £250,000 but had had £210,000 written off during the course of years, or plant which had cost £50,000 and in respect of which only £10,000 had been provided for depreciation to date.

If a deduction for depreciation was shown on the face of the Balance Sheet it was usually the current year's provision only; previous provisions were lost in the net balance brought forward from the previous year.

The rules now in force, under the 1948 Act, go very much further, First, "the method or methods used to arrive at the amount of the fixed assets under each heading shall be stated" (4 (3)). Secondly, "the method of arriving at the amount of any fixed asset shall, subject to the next following sub-paragraph [which deals with four exceptions considered later], be to take the difference between (*a*) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and (*b*) the aggregate amount provided or written off since the date of acquisition or valuation as the case may be, for depreciation or diminution in value" (5 (1)).

Of course, the old method of stating fixed assets at cost less depreciation showed the difference between cost and aggregate depreciation to date; however, it is not now sufficient to "take the difference" for it is further provided—

> "For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph there shall be shown—
> (*a*) the aggregate of the amounts referred to in paragraph (*a*) of that sub-paragraph ; and
> (*b*) the aggregate of the amounts referred to in paragraph (*b*) thereof" (5 (3)).

For each fixed asset (or group of fixed assets dealt with under one heading in the Balance Sheet) it is therefore necessary to show three figures:

(1) Its cost (or where, for example, following some re-organization of capital, it stands in the books at a valuation, that valuation).

(2) The total amount provided for depreciation since the date of

acquisition (or the date of valuation, as the case may be), whether that depreciation has in fact been written off by writing down the value of the asset in the company's books or has been accumulated in a separate account in the books.

(3) The balance obtained by deducting (2) from (1), which is in fact the net book value of the asset at the date of the Balance Sheet.

Example

A company which has, in the past, depreciated its plant by the reducing-balance method, has a balance brought forward at the beginning of the year on Plant Account of £90,000. By extracting all the entries in Plant Account back to the incorporation of the company it is found that this balance represents:

	Dr.	Cr.
Cost of Plant purchased	£200,000	
Proceeds of sale of Plant (original cost of the plant sold, £35,000)		£10,000
Depreciation and losses on sale written off		£100,000

Additional plant acquired during the year cost £20,000; this replaced old plant which had originally cost £10,000 and in respect of which the written-down value at the beginning of the year was computed to be £4,000. The old plant was sold as scrap for £100.

Depreciation for the year is to be written off at 5 per cent on the balance brought forward plus the additions. The loss on sale of the old plant is also to be written off.

The necessary calculations (*a*) to provide for depreciation and balance the books, and (*b*) to comply with the Act, can conveniently be combined and set out in the following way:

		Book Value	Cost	Depreciation
		£	£	£
Acquired before beginning of year			200,000	100,000
Less Sold before beginning of year			35,000	25,000
Balance brought forward		90,000	165,000	75,000
Additions		20,000	20,000	
		110,000	185,000	
	£			
Less Sales—Proceeds	100			
Depreciation and Loss on Sale	3,900	4,000	10,000	6,000
		106,000	175,000	69,000
Depreciation for year at 5 per cent		5,300		5,300
		£100,700 =	£175,000 less	£74,300

The Plant Account will then be closed as follows:

		£		£
To Balance b/f		90,000	By Proceeds of Sale	100
Sundries (Addn.)		20,000	Depreciation and Loss on Sale, written off	9,200
			Balance c/d	100,700
		£110,000		£110,000
To Balance b/d	£			
Cost	175,000			
Less Depn.	74,300			
		£100,700		

and the relevant entry in the Balance Sheet will be:

	Fixed Assets:		
		£	£
	Plant, at cost	175,000	
	Less Depreciation	74,300	
			100,700

NET BOOK AMOUNT

The foregoing may be regarded as the normal method of stating fixed assets in any Balance Sheet presented after July 1, 1948. It has to be recognized, however, that many existing companies, having for many years written off depreciation in their books and having only recorded the net values brought forward of such fixed assets, will be unable without unreasonable expense or delay to ascertain the original cost and total depreciation provisions to date in respect of some of their fixed assets.

Paragraph 5 (1), already quoted, proceeds to meet this difficulty: "for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at the commencement of this Act and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets."

It will be noted that this alternative is not open to all companies—it is necessary to show that unreasonable expense or delay would be involved if the main provisions of paragraph 5 were applied. Further, even if this alternative is adopted in regard to assets acquired before the commence-

ment of the Act (July 1, 1948), it does not apply to assets subsequently acquired.

Also, the fact that it is impossible to ascertain the cost (and total depreciation thereon to date) of some of the old assets does not make it impossible to apply the main provisions to others, for which the information is readily available, or can be obtained without unreasonable expense or delay. Thus, one part of the balance on a fixed asset account may fall to be dealt with in one way and the remainder in another; when the separate figures have been calculated, however, they must be brought together to give the aggregate required by the Act.

Example

On July 1, 1948, the balance on Plant Account in a company's books was £45,000. It was ascertained that part of this balance represented plant (all then in use) which had originally cost £75,000 and in respect of which £40,000 had been written off for depreciation. It was not possible without unreasonable expense or delay to ascertain the composition of the remaining £10,000.

Since July 1, 1948, new plant has been acquired at a total cost of £20,000. The appropriate figures for the same period (that is, from July 1, 1948, to the date of the Balance Sheet which is being considered) regarding depreciation and sales of plant are as follows:

	Depreciation written off (See Note 1)	*Plant Sold*		
		Proceeds	*Book Value*	*Cost*
	£	£	£	£
Plant acquired before July 1, 1948:				
(*a*) Included in the £75,000	12,000	500	2,000	10,000
(*b*) Included in the £10,000 balance	4,000	100	300 (see Note 3)	1,200 (see Note 2)
Plant acquired after July 1, 1948 (i.e., part of the £20,000)	6,000	800	750	1,000
	£22,000	£1,400	£3,050	£12,200

Notes. (1) Including any amounts which relate to the plant that has been sold since July 1, 1948.

(2) Being estimated book value at July 1, 1948, the original cost and the amount of depreciation written off before July 1, 1948, not being known.

(3) This is also estimated, by depreciating the estimate of £1,200 from July 1, 1948, to the date of sale, at the rate of depreciation known to have been applied to the account as a whole.

To obtain the requisite totals for the Balance Sheet, the figures are brought together in the following way:

	Cost £	£	*Depreciation* £	£
(*a*) Plant of which the cost is known:				
Acquired before July 1, 1948	75,000		40,000	
			12,000	
			52,000	
Less Sold since July 1, 1948	10,000		8,000	
		65,000		44,000
Acquired since July 1, 1948	20,000		6,000	
Less Sold since July 1, 1948	1,000		250	
		19,000		5,750
		£84,000		£49,750
(*b*) Plant of which the cost is not known:	*Book Value July* 1, 1948			
As at July 1, 1948	10,000			
Depreciation written off since July 1, 1948			4,000	
Less Sold since July 1, 1948	1,200		900	
		8,800		3,100
Totals of (*a*) and (*b*)		£92,800		£52,850

If only one Plant Account is maintained in the ledger, the entries in it for all years since July 1, 1948, may be summarized as follows:

	£		£
To Balance b/f	45,000	By Depreciation	22,000
Additions	20,000	Sales	1,400
		Losses less profits on sale, w/o (£3,050 − £1,400)	1,650
		Balance c/d	39,950
	£65,000		£65,000
To Balance b/d	39,950		

The calculations would have been simplified if separate accounts had been maintained as from July 1, 1948, for:

Account	*Balances at* *July* 1, 1948 £	*Balance Sheet Date* £
Plant, at cost	75,000	84,000
Plant, at book value, July 1, 1948	10,000	8,800
Depreciation on Plant at cost	40,000	49,750
Depreciation on Plant at book value July 1, 1948	—	3,100

The figures can be shown in the Balance Sheet in various ways, of which the following are two examples:

	£	£
(1) *Fixed Assets:*		
Plant:		
At cost (and where figures for cost are not reasonably obtainable, at the net amount standing in the company's books on July 1, 1948, less sales)	92,800	
Less Depreciation	52,850	
		39,950

(2) *Fixed Assets:*	*Cost, etc.* £	*Depreciation* £	£
Plant:			
At cost less depreciation	84,000	49,750	
At the net amount standing in the company's books on July 1, 1948	8,800	3,100	
	£92,800	£52,850	
			£39,950

Example (1) is sufficient to comply with the strict requirements of the 8th Schedule, but example (2) is to be preferred on the ground that it gives a "true and fair view."

EXCEPTIONS

The four exceptions to the general rule referred to previously are as follows:

(1) Assets for which the figures relating to the period beginning with the commencement of the Act (July 1, 1948) cannot be obtained without unreasonable expense or delay.

This will enable such fixed assets as loose tools to be dealt with by the normal method of taking an annual inventory. It would not be reasonably possible to keep detailed records of the cost and depreciation written off to date in respect of each tool.

(2) Assets the replacement of which is provided for wholly or partly (*a*) by making provision for renewals and charging the cost of replacement against the provision so made, or (*b*) by charging the cost of replacement direct to revenue. Where any assets are dealt with in this way, however, it is necessary to state the means by which their replacement is provided for and the aggregate amount of the provision (if any) made for renewals and not used.

(3) Investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note (see page 288).

(4) Goodwill, patents and trade marks (see page 286) (5 (2)).

DEPRECIATION RESERVES

Before the 1948 Act came into force some companies provided for depreciation of fixed assets not by writing off depreciation annually but by building up a Depreciation Reserve, which appeared on the liabilities side of the Balance Sheet. Occasionally, depreciation reserves were built up in addition to the normal writing-off procedure; such reserves were useful in retaining profits within the business when it was feared that fixed assets would have to be replaced eventually at a much higher price level than that ruling when they were originally acquired.

In Balance Sheets presented after July 1, 1948, such reserves must be brought across and shown as a deduction from the relative asset or assets. Where only one Depreciation Reserve has been built up against assets which have to be shown under more than one heading, it will be necessary to apportion it over the various assets concerned. The directors of the company are responsible for such an apportionment.

If, however, this would result in any asset being written down by an amount which "is in excess of that which in the opinion of the directors is reasonably necessary for the purpose" the excess has to be treated as a reserve and not as a provision. The effect of this is that, to that extent, the old Depreciation Reserve remains on the liabilities side of the Balance Sheet and is grouped with the undistributed profits (the distinction between reserves and provisions is considered more fully later).

It may be noted that, so far as values at July 1, 1948, are concerned, while an excessive amount "retained by way of providing for depreciation, renewals or diminution in value of assets" (that is, the old Depreciation Reserve referred to in the preceding paragraph) has to be treated as a reserve, this does not apply to an excessive amount *written off* before the Act came into force. Any excessive amounts provided *after* July 1, 1948, however, whether actually written off the assets or not, must be treated as reserves and not as provisions. This is part of the procedure adopted in the Act to prevent the creation of secret reserves (see page 293).

GOODWILL, PATENTS AND TRADE MARKS

It is necessary to show under a separate heading in the Balance Sheet "If the amount of the goodwill and of any patents and trade marks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is so shown or ascertainable and as so shown or ascertained, as the case may be" (8 (1) (*b*)).

"Nothing in head (*b*) of the foregoing sub-paragraph shall be taken as requiring the amount of the goodwill, patents and trade marks to be stated otherwise than as a single item" (8 (2)).

It has been noted already that this item provides one of the four exceptions to the normal method of valuation of fixed assets. Conse-

quently, if anything has been written off this asset, its present written-down value only need be shown; the original cost (or valuation) and total depreciation to date are not required.

Goodwill, although intangible, is as much a fixed asset as are land and buildings, plant and machinery. The reason for excepting it from the general rule is that it is not essentially a wasting asset; it may, and often does, increase in value with the age of the business. Patents and trade marks have a limited life and may therefore be regarded as wasting assets, but their value is usually so mixed up with that of goodwill that the three items are normally dealt with as one. If the company wishes to do so there is, of course, nothing to prevent it showing the separate values.

PRELIMINARY EXPENSES

Every Balance Sheet issued by a company must show under separate headings outstanding balances of:

(1) preliminary expenses;

(2) expenses incurred in connexion with any issue of share capital or debentures;

(3) sums paid by way of commissions in respect of any shares or debentures;

(4) sums allowed by way of discount in respect of any debentures; and

(5) discount allowed on any issue of shares at a discount.

If amounts have to be disclosed under more than one of these headings they should preferably be grouped under a suitable main heading such as "capital expenditure not yet written off." The expression "fictitious assets," although sometimes used, is not recommended as a Balance Sheet heading.

INVESTMENTS

Investments held by a company must be shown in its Balance Sheets under the following separate headings (8 (1) (*a*)):

(1) Trade investments. This expression is not defined in the Act but is taken to mean investments acquired for the purposes of furthering the main business of the company, for example, shares in an associated company (but not shares in a subsidiary company, for these are subject to special rules).

(2) Quoted investments other than trade investments.

(3) Unquoted investments other than trade investments.

The expression quoted investment means an investment respecting which there has been granted a quotation or permission to deal on a recognized stock exchange, or on any stock exchange of repute outside Great Britain (28).

Shares in subsidiary companies must be excluded from all the foregoing headings as they are dealt with separately.

It must not be overlooked that most companies can acquire investments either as fixed or as current assets. The intention with which they were acquired normally determines into which of these two classes they fall. Although there is no specific provision to that effect, any investments

held for the purpose of a sinking fund, pension fund or other separately invested fund should be so described; if this is not done the Balance Sheet is not likely to show a true and fair view.

One form of sinking fund is the purchase of a company's own debentures in the name of a nominee or trustee for the company. This is specifically mentioned: "Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated" (10).

The foregoing rules in regard to the disclosure of investments under various headings do not impose any obligation upon the company in regard to the value at which they are carried in the books and shown in the Balance Sheet. If they are held as current assets, the ordinary principles of accountancy would demand that they be valued at the lower of cost or market value, because depreciation of current or floating assets must be provided for before any profits can be said to have been earned. Where, however, they are held as fixed assets, cost would be the normal method of valuation; this may, of course, be more or less than current market value.

Except where trade investments are concerned, market values must nevertheless be disclosed: "The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value" (11 (8)).

The purpose of the proviso in regard to stock exchange value is a little difficult to follow as where there is a stock exchange value that would normally be the market value. Exceptional cases might arise, however.

The information required in regard to market value is normally given "inset" or in the form of a note appended to the Balance Sheet.

FOREIGN ASSETS

Companies with one or more overseas branches will have assets abroad, the value of which has to be arrived at by converting a value in foreign currency into the equivalent value in sterling. (The principles involved in making these conversions are considered in Chapter XVII.)

The Balance Sheet must contain a note stating "the basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material" (11 (9)).

Subject to this note being given, the foreign assets (and liabilities) will be grouped under the appropriate headings according to their nature, and need not be shown separately.

COMPARATIVE FIGURES

"Except in the case of the first Balance Sheet laid before the company after the commencement of the Act (July 1, 1948), the corresponding amounts at the end of the immediately preceding financial year for all items shown in the Balance Sheet must be given" (11 (11)).

The "end of the immediately preceding financial year" means, in effect, the date of the last Balance Sheet to be presented to the members; the intervening period in exceptional cases may be more or less than a year.

The necessity for providing this comparison may add considerably to the difficulty of laying out the Balance Sheet in a convenient manner. This difficulty may sometimes be surmounted by inserting one figure only under each heading on the face of the Balance Sheet proper, any additional information required being relegated to suitable notes or schedules annexed to the Balance Sheet. It is also becoming increasingly common to ignore shillings and pence in published accounts.

VALUATION OF CURRENT ASSETS

If in the opinion of the directors any of the current assets have not a value, on realization in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion must be given in a note (11 (7)).

Since the proper basis of valuation of current assets is cost or realizable value, whichever be the lower, this provision is not often likely to apply. Its chief purpose would appear to be to confirm the view that this is the proper method of valuing current assets and to cast a specific responsibility upon directors in cases where it is not applied.

LIABILITIES

Just as assets fall into two main groups, fixed and current, so the principal division of liabilities is into the following two categories:

(1) *Current Liabilities.* This heading embraces not only those liabilities which were actually due for payment at the date of the Balance Sheet but also those which will become due within a short period thereafter. Thus, trade creditors (whether payable immediately or under the ordinary terms of credit within perhaps the next six months), dividends recommended to be paid in respect of the year (but generally not actually payable until after the general meeting, some three to six months later), and income tax payable on the following January 1, in respect of the year of assessment in which the company's financial year ends, would all be covered by the general description "current liabilities."

(2) *Deferred* (*or Long Term*) *Liabilities.* This general description is sometimes used to describe all liabilities other than current liabilities. It thus covers debentures and other loans.

The terms current and deferred are not in fact used or defined in the Companies Act, 1948, but the general instruction in paragraph 2 of the 8th Schedule, calling for such particulars as are necessary to show the general nature of the assets and liabilities, implies that some such separation should be made.

One of the first points to be considered in the interpretation of any Balance Sheet is the comparison of the current assets with the current liabilities; any grouping which does not enable this comparison to be

made cannot be said to show a true and fair view of the state of the company's affairs.

A mere division of the liabilities into current and deferred, with one total under each heading, is rarely sufficient. The following specific provisions of the 8th Schedule, requiring separate disclosure of certain items, must always be borne in mind:

"8. (1) There shall be shown under separate headings:

(*d*) the aggregate amount of bank loans and overdrafts;

(*e*) the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend.

"9. Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured shall be stated, but it shall not be necessary to specify the assets on which the liability is secured."

The words "otherwise than by operation of law" restrict the operation of paragraph 9 to cases where the company has actually given some charge or pledge in regard to its assets. A security by operation of law might arise where a trade creditor is able to claim that he has a lien on goods belonging to the company; in the event of liquidation such a creditor might properly be regarded as secured, but so far as Balance Sheets are concerned it is not necessary to extract such items from the item Trade Creditors.

A bank overdraft must be described as secured only if it is secured on assets belonging to the company. If it has been secured by the personal guarantees of the directors or other persons, or on property put up by them as security, but there is no debenture or other charge on the company's own assets, then the overdraft should not be described as secured. It must still be shown separately, however, to comply with Paragraph 8 (1) (*d*).

Debentures usually, but not necessarily, carry a charge on some or all of the company's assets; if so, the word secured should be added in parentheses to their description unless they are already described as mortgage debentures.

The correct treatment of taxation liabilities is considered later.

CONTINGENT LIABILITIES

The following matters must be stated by means of a note, or in a statement or report annexed to the Balance Sheet, if not otherwise shown:

(1) "The amount of any arrears of fixed cumulative dividends on the company's shares and the periods for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated before deduction of income tax, except that, in the case of tax free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated" (11 (3)).

Such arrears of dividends are not liabilities in the strict sense, but the amounts involved must be shown to enable the respective values of different classes of shares to be assessed. The amounts cannot be brought into the books as an actual liability, for usually there are no profits available for that purpose.

The reason for stating the gross amount (whereas dividends, declared or recommended, are stated "net") is that if and when the arrears are paid, tax will be deducted at the standard rate in force when the payment is made—not the rates applicable in the years during which the arrears accumulated.

(2) "Particulars of any charge on the assets of the company to secure the liabilities of any other person, including where practicable, the amount secured" (11 (4)).

Where the "other person" is an officer of the company (for instance, a director) this provision must be read in conjunction with Section 197 (see page 273).

(3) "The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material" (11 (5)).

The commonest example of a liability which has to be disclosed in this way is the contingent liability which arises when bills receivable have been discounted. The aggregate amount which has to be disclosed is the gross liability that could arise if the contingency happens, and does not indicate the amount which is expected to arise. On the contrary, if there is reason to expect any loss from a contingency, that loss must be provided for as though it were an actual liability.

(4) "Where practicable, the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure" (11 (6)).

Such expenditure does not involve any loss, but its effect will be to increase the fixed assets at the expense of the current assets. It would be misleading to present a Balance Sheet showing an apparently satisfactory working-capital position (that is, an excess of current assets over current liabilities) without referring to the existence of contracts involving heavy capital expenditure in the near future.

Where, under such a contract, an amount is already due for payment it will, of course, be brought in as a current liability and regarded as an addition already made to the fixed assets concerned. The note referred to here therefore relates to items which will become due for payment in the ensuing period; for example, under a contract for the rebuilding of the company's factory, payments being made on architect's certificate as the work proceeds.

PROVISIONS

The expression provision is defined by Paragraph 27 (1) (*a*) of the 8th Schedule as meaning "any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy."

It is not sufficient, however, that the amount should originally have been written off or retained for one of the foregoing purposes; it must still (with one exception regarding depreciation written off before 1 July, 1948) be reasonably necessary for that purpose, for where:

"(*a*) any amount written off or retained by way of providing for depre-

ciation, renewals or diminution in value of assets (not being an amount written off in relation to fixed assets before the commencement of the Act): or

(*b*) any amount retained by way of providing for any known liability is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision" (27 (2) (*a*)).

Where a provision is an amount retained to provide for a known liability (of which the amount cannot be determined with substantial accuracy), the expression liability is defined as including "all liabilities in respect of expenditure contracted for and all disputed and contingent liabilities" (27 (1)).

RESERVES

Subject to any special provisions in the company's Articles, the directors are entitled to set aside part (or even the whole) of the profits as a reserve or reserves. Reserves may be created, under suitable names, for various purposes. Thus, a Debenture Redemption (or Sinking) Fund is an example of the setting aside of profits for a specific purpose, which, of course, has the effect of reducing the balance of profit available for dividend. Even the balance carried forward on Profit and Loss Account is a form of reserve.

The powers of the directors in this respect are well defined by Clause 117 of Table A to the 1948 Act:

"117. The directors may, before recommending any dividend, set aside out of the profits of the company such sums as they think proper as a reserve or reserves which shall, at the discretion of the directors, be applicable for any purpose to which the profits of the company may be properly applied, and pending such application may, at the like discretion, either be employed in the business of the company or be invested in such investments (other than shares of the company) as the directors may from time to time think fit. The directors may also without placing the same to reserve carry forward any profits which they may think prudent not to divide."

Where Redeemable Preference shares are redeemed out of profits, the Capital Redemption Reserve Fund is an example of a reserve created to comply with the requirements of the Act, and not merely at the discretion of the directors or shareholders.

For the purpose of disclosure in Balance Sheets, the expression reserve is defined (in a negative way) as being, in effect, any amount which has been set aside and which does not fall to be regarded as a provision as already defined. A distinction is also drawn between a capital reserve and a revenue reserve.

Thus, "the expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account," and "the expression 'revenue reserve' shall mean any reserve other than a capital reserve."

The following are capital reserves and should be grouped accordingly: Capital Redemption Reserve Fund, Share Premium Account, Profits

Prior to Incorporation, and a reserve arising from an unrealized appreciation in value of fixed assets, which has been brought into the company's books as a result of a revaluation of its assets.

The following are revenue reserves: General Reserve, Dividend Equalization Reserve, Debenture Redemption Reserve (since there is nothing in the Act to require such a reserve to be treated as capital), and the balance carried forward on Profit and Loss Account.

SECRET RESERVES

The view was at one time commonly held that, while in no circumstances ought a Balance Sheet to overstate a company's financial position, it could (and in some cases should) understate it. This understatement was brought about by the process of creating secret reserves, that is, by creating reserves as now defined, but hiding their existence by taking them into the Balance Sheet under the omnibus heading of Sundry Creditors. In other cases the same result was achieved by the deliberate undervaluation of assets.

In 1906 the Birmingham Small Arms Co., Ltd., sought to alter its Articles by special resolution in order to empower the directors to set aside profits to an internal reserve fund which need not be shown or disclosed on the Balance Sheet and to bind the company's auditors not to "disclose any information with regard to the same to the shareholders or otherwise." The proposed new Article was held by the High Court to be invalid because it constituted an infringement of the unfettered right of the auditors to report on the affairs of the company to its members.

However, the creation of internal, or secret, reserves seems to have received judicial approval, for Mr. Justice Buckley in the course of his judgment said: "The purpose of the Balance Sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better. The provision as to not disclosing the internal reserve fund in the Balance Sheet is not, I think, necessarily fatal to the special resolutions."

The creation of secret reserves may have been defensible on the grounds of prudence and may, perhaps, be regarded as in the interests of the shareholders in the company. The creation of such reserves, however, implied that they would eventually be used; in other words, they would be created in times of prosperity and drawn upon in times of depression. It began to be realized that in the undisclosed use of secret reserves, to supplement the profits of a bad year, lay the seeds of many abuses.

The change in public and judicial opinion between 1906 and 1931 is well illustrated by this extract from Mr. Justice Wright's summing up in the case of *Rex* v. *Kylsant:* "It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of companies . . . have very large portions of the company's assets left in the secret disposition of the

managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. *On the other hand, it may be the subject of almost intolerable abuse*."

The following requirements of the 8th Schedule to the 1948 Companies Act now put the legal position beyond any doubt.

"The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings:

"Provided that—

"(*a*) this paragraph shall not require a separate statement of any of the three amounts which is not material; and

"(*b*) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that this is not required in the public interest and would prejudice the company, but subject to the conditions that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact" (6).

The authority of the Board of Trade to amend the requirements in certain cases is additional to the special exemptions granted to certain classes of companies (for example, banking or assurance) which are considered later.

In addition to the foregoing provisions of Paragraph 6 requiring disclosure of the relative amounts at the date of each Balance Sheet, any changes in those amounts from one year to another have to be explained.

"(1) There shall also be shown (unless it is shown in the Profit and Loss Account or a statement or report annexed thereto, or the amount involved is not material)—

"(*a*) Where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and

"(*b*) Where—

"(i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or

"(ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;

the application of the amounts derived from the difference.

"(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof" (7).

The qualification "unless it is shown in the Profit and Loss Account" should be noted, for in the great majority of cases changes in reserves will of necessity be shown in the Profit and Loss Account. For example, a transfer from Profit and Loss Account to Capital Redemption Reserve Fund on the redemption of Redeemable Preference shares, an appropriation of profits to a Debenture Redemption Fund or a transfer to General Reserve recommended by the directors for approval at the ensuing annual general meeting would all, of necessity, be reflected by debit items in the Profit and Loss Appropriation Account; a further explanation on the face of the Balance Sheet is then unnecessary.

If, however, the amount required to be transferred to Capital Redemption Reserve Fund is drawn from General Reserve, so that, to that extent, it does not appear in the Profit and Loss Account, then an explanation must be given either in the Balance Sheet or in a report or statement. Similarly, if the transfer is made from Share Premium Account to capital Redemption Reserve Fund, although this is a transfer from one capital reserve to another, which does not, therefore, alter the "aggregate amount of capital reserves," two sub-headings of that aggregate are affected and the explanation must be given.

TAXATION

In times of high taxation, the making of adequate provision for a company's taxation liability is of the utmost importance in assessing its financial position and a Balance Sheet which did not make such provision could not be said to exhibit a true and fair view. Such provision, if excessive (or if ultimately found to be unnecessary), may also introduce some of the undesirable features of secret reserves. It is therefore necessary to consider whether an amount set aside for taxation falls properly to be regarded as a provision or as a reserve and to group it in the Balance Sheet accordingly.

For this purpose taxes may be considered under two headings:

(1) Taxes such as profits tax, which are based on the actual profits (adjusted to give effect to the taxation laws concerned) of the company's financial year.

The amount payable, out of the profits of a given year, in respect of such a tax is a liability which must be provided for. It is in the nature of a current liability since it is presently payable, but as it will not usually be ascertainable exactly until the accounts have been agreed with the Inland Revenue, it may well fall under the heading Provisions.

The amount provided may ultimately be found to be more or less than is required to meet the liability when assessed; if the difference is material the accounts must show how it has been dealt with; if in excess, it might be transferred back to Profit and Loss Account or retained to meet part of the provision required for the following year.

(2) Income tax, which is assessed for each fiscal year commencing April 6, the assessment normally being based on the (adjusted) profit for the company's financial year ending within the preceding

fiscal year. There are, however, special rules which apply during the opening and closing years of a company's existence.

Income tax assessed for a given fiscal year is payable on January 1. The liability for the current year (that is, the fiscal year within which the company's financial year ends) being based on the profits of the period which ended a year ago, will usually have been agreed with the Inspector of Taxes. At the date of the Balance Sheet it will either have been paid (for example, where the company's year ends on, say, February 28 and the income tax liability was paid promptly on, or soon after, January 1), or will be brought into account as a current liability.

In addition to this current liability, many companies deem it prudent to reserve for the income tax that will be payable, one year later, in respect of the profits of the current financial year. This is usually referred to as future taxation. An amount so set aside should be treated as a reserve, and not as a provision, because:

(1) The liability relates to the future period and not to the current period, even though it is based on the profit of the current period.

(2) In certain events (such as the liquidation of the company) it may never have to be paid.

(3) As the rate of tax is often not known when this reserve is created (the standard rate of tax is fixed annually in April) and the adjusted profit cannot yet have been agreed, it may only be possible to make a rough estimate of the liability.

One of the advantages of the system of reserving for future tax is that, where this system has been consistently followed for at least two years, the amount to be provided out of profits each year is the income tax that will eventually be payable in respect of those profits.

The Companies Act, 1948, does not attempt to say *how* taxation liabilities ought to be dealt with, but the Balance Sheet must disclose "the basis on which the amount, if any, set aside for United Kingdom income tax is computed" (11 (10)), and, in the Profit and Loss Account must be shown "the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits . . . distinguishing where practicable between income tax and other taxation" (12 (1) (*c*)). (The words omitted deal with double-taxation relief, which may arise where part of the profits have already been taxed abroad.)

TAXATION ACCOUNT

The best way to maintain the distinction between income tax and other taxes is to open separate accounts for them in the General Ledger. Income tax may, however, be payable under more than one schedule or partly by assessment and partly by deduction; all amounts should be recorded in or transferred to one account for Income Tax so that the Profit and Loss Account can ultimately be debited with one amount for income tax each year.

Tax suffered (or recovered) by deduction is brought into account by the process of "grossing up." Thus, interest on an investment held by the company will, usually, be received "less tax." The net amount

received will be entered in the Cash Book (Dr.) and posted to the credit of Interest and Dividends Receivable Account. A journal entry is then made transferring the amount of the tax deduction from the debit of Income Tax Account to the credit of Interest and Dividends Receivable.

By a reverse process, interest paid under deduction of tax is grossed up and Income Tax Account is credited with the tax so recovered, as explained on page 255. (In assessing the profits of the company, interest paid under deduction of tax is added back, so that the amount assessed is the profit plus the interest; in this way the company automatically accounts for the tax deducted.) Dividends paid, however, are not subject to this grossing-up process.

Example (a)

A company makes up its accounts annually to September 30. During the year ended September 30, 1948:

(1) It paid debenture interest amounting to £2,000 gross, less tax at 9s., £900 = £1,100 net.

(2) It received a dividend of £550 free-of-tax from another company in which it held shares. (This is equivalent to £1,000 gross less £450 tax.)

(3) It paid income tax for 1947–48 on January 1, 1948, as follows: (*a*) Under Schedule A in respect of its business premises, which it owned, £400 at 9s. = £180; (*b*) Under Schedule D in respect of its adjusted profit for the year ended September 30, 1946, £10,000 at 9s. = £4,500.

The assessments for 1948–49 (for which year the standard rate of tax was again 9s. in the £) were: Schedule A £400, Schedule D £12,100. (In the Balance Sheet at September 30, 1947, tax on £12,000 at 9s., £5,400, had been reserved for, in respect of future taxation.)

The adjusted profit for the year ended September 30, 1948, is expected to be about £15,000 and future taxation is to be reserved for accordingly, on the assumption that the rate of tax will remain 9s. in the £ for the year of assessment 1949–50. Income tax payable under Schedule A is provided for on a strict accruals basis.

The entries in Income Tax Account will be as follows:

1948		£	1947		£
Jan. 1	To Cash:		Oct. 1	By Balance b/f:	
	Schedule A	180		Sch. A 1947/48,	
	Schedule D	4,500		½ of £180	90
?	Dividends Received	450		Sch. D 1947/48	4,500
Sept. 30	Balances c/d:			Sch. D 1948/49	5,400
	Sch. A 1948/49,				
	½ of £180	90			9,990
	Sch. D 1948/49	5,445	?	By Debenture Int.	900
	Sch. D 1949/50		Sept. 30	By Profit and Loss Appropriation A/c	
	£15,000 at 9s.	6,750			6,525
		£17,415			£17,415
			1948		
			Oct. 1	By Balance b/d	12,285

Notes. (1) Of the balances carried down at September 30, 1948, totalling £12,285, the amounts relating to the current year, 1948–49

(namely, £90 + £5,445 = £5,535), will be treated as a current liability or provision, while the amount relating to 1949–50 (namely, £6,750) will be treated as a reserve.

(2) The amount to be debited to Profit and Loss Appropriation Account represents:

(*a*) Tax payable on the profits of the year ended September 30, 1948, namely:	£	
Under Sch. D (assessable in 1949–50)	6,750	
Under Sch. A (assessable partly in 1947–48 and partly in 1948–49)	180	
By deduction from dividend received	450	
	7,380	
Less Recouped by deduction from debenture interest	900	
		6,480
(*b*) Under reserve for income tax (1948–49) in the previous year		45*
		£6,525

* This need not be shown separately as it is not material in relation to the amounts as a whole. It must be borne in mind that the reserve of £6,750 for the 1949–50 Schedule D liability is itself only an estimate.

Example (*b*)

The same company had made a provision of £1,200 for profits tax for the year ended September 30, 1947, when drawing up the Balance Sheet as on that date. Owing to a subsequent distribution of profits this liability was eventually agreed at £1,900, which amount was paid on May 1, 1948. It was decided to provide £2,000 in respect of profits tax for the year ended September 30, 1948.

The entries in Profits Tax Account will be as follows:

1948		£	1947		£
May 1	To Cash	1,900	Oct. 1	By Balance b/f	1,200
Sept. 30	Balance c/f—Provision for Profits Tax to date	2,000	Sept. 30	Profit and Loss A/c: Profits Tax	2,000
				Adjustment of liability for previous year	700
		£3,900			£3,900
			1948		
			Oct. 1	By Balance b/d	2,000

Note. The adjustment of the previous year's liability, resulting in an additional debit to Profit and Loss Account of £700, is material in relation to the other figures and must therefore be shown separately in the Profit and Loss Account.

The following provisions of the 8th Schedule relate to a company's share capital:

"The authorized share capital, issued share capital, liabilities and assets shall be summarized, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there shall be specified—

"(*a*) any part of the issued capital that consists of Redeemable Preference shares, and the earliest date on which the company has power to redeem those shares;

"(*b*) as far as the information is not given in the Profit and Loss Account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid"; (this arises under the little-used provisions of Section 65, whereby if "any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up . . ." It is, however, necessary to obtain the consent of the Board of Trade before any such payment is made, and other stringent safeguards are provided by the Section).

"(*c*) the amount of the Share Premium Account;

"(*d*) particulars of any redeemed debentures which the company has power to reissue" (2).

It is also necessary to state, by way of note if not otherwise shown, "the number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say (*a*) the period during which it is exercisable; (*b*) the price to be paid for shares subscribed for under it" (11 (2)).

If the issued capital is not fully paid, either because it has not yet been fully called up or because there are calls in arrear, then (although the Act is silent on this point) it is customary:

(1) To state the issued capital (under separate sub-headings for each class of shares) at its called-up value, and

(2) To show the amount of calls in arrear (if any) as a deduction therefrom.

Example

The authorized capital of PQ, Ltd., is £500,000, divided into 200,000 6 per cent Redeemable Preference shares of £1 each and 600,000 Ordinary shares of 10s. each. On December 31, all the Redeemable Preference shares had been issued at a premium of 1s. per share and paid for in full. They are redeemable at the option of the company on or after January 1, 1970.

400,000 of the Ordinary shares had been issued and 7s. 6d. per share had been called up thereon. On December 31 calls amounting to

£4,000 were in arrear. P has an option to subscribe at par for 100,000 of the unissued Ordinary shares at any time during the next three years.

The relevant entries in the Balance Sheet as at December 31 will be as follows:

Authorized Share Capital:		
200,000 6 per cent Redeemable Preference shares of £1 each		200,000
600,000 Ordinary shares of 10s. each		300,000
		£500,000
Issued Share Capital:		
200,000 6 per cent Preference shares of £1 each, fully paid		200,000
400,000 Ordinary shares of 10s. each, 7s. 6d. per share called up	150,000	
Less Calls in Arrear	4,000	
		146,000
		346,000
Capital Reserves:		
Share Premium Account		10,000

Notes appended to the Balance Sheet:

(1) The earliest date on which the company has power to redeem the Redeemable Preference shares is January 1, 1970.

(2) 100,000 of the unissued Ordinary shares are under option to be subscribed at par at any time during the next three years.

PROFIT AND LOSS ACCOUNTS—GENERAL PRINCIPLES

In addition to the detailed requirements of the 8th Schedule regarding the matters which have to be disclosed separately in a company's Profit and Loss Account, the important general principle is laid down that "every Profit and Loss Account of a company shall give a true and fair view of the profit or loss of the company for the financial year" (S. 149 (1)).

After the profit for the year has been determined, it is added to the balance, if any, brought forward from the previous year; and out of the total amount thus made available, dividends are recommended to be paid and other appropriations are made. The "true and fair view of the profit . . . for the financial year" is best given by dividing the published Profit and Loss Account into two sections, of which:

(1) The first is the Profit and Loss Account proper, showing the net profit or loss for the year before making any appropriations and before bringing in any balance from a previous year.

Subject to the provisions of the 8th Schedule which require certain items, such as depreciation and debenture interest, to be shown

separately, it is left to the discretion of the directors to give as much or as little detailed information as they think fit. The published accounts of a public company rarely give much more detail than is required as a minimum by the Act. Private companies, on the other hand, frequently provide their members with the detailed Trading and Profit and Loss Accounts that are prepared by or for the management.

(2) The second is really the Appropriation Account. The net profit (or loss) for the year is brought down to it from the Profit and Loss Account, the balance from the previous year is brought in and appropriations (or proposed appropriations) are shown.

RELATIONSHIP TO BALANCE SHEET

The elementary principles of double-entry book-keeping demand that every transaction should be regarded from two points of view; these are reflected in the books by debit and credit entries respectively.

When this elementary principle is applied to the closing entries made at the end of a financial year, it is found, more often than not, that the two points of view are those of the Balance Sheet and the Profit and Loss Account or, in other words, capital and revenue respectively. Consequently, the correct treatment of an item (such as the valuation of an asset or a provision for an expense) for the purpose of the Balance Sheet affects the correct calculation of the year's profit or loss. In fact, the general instructions in the Act requiring the Balance Sheet to give a true and fair view of the state of affairs, and the Profit and Loss Account to give a true and fair view of the profit or loss, are complementary.

REQUIREMENTS OF THE ACT

Most of the requirements of the Act which have a bearing upon the Profit and Loss Account have already been considered under the appropriate heading. The following summary of the items which (so far as they are applicable) must be shown in any Profit and Loss Account submitted by a company to its members should be regarded as an essential minimum of disclosure; in some circumstances the overriding provision for a "true and fair view" might require other details to be disclosed.

Summary of matters required to be shown in the Profit and Loss Account of a Company

(References are to the 8th Schedule of the 1948 Act unless otherwise stated).

(1) Matters which are normally shown in the Profit and Loss Account before the profit or loss for the year is stated.

(*a*) Provision for depreciation, renewals or diminution in value of fixed assets (12 (1) (*a*)).

(*b*) Interest on debentures and other fixed loans (12 (1) (*b*)).
(The amount shown should be gross, before deduction of income tax.)

(*c*) United Kingdom taxation on profits, other than income tax

(12 (1) (*c*)). (Strictly, income tax is an appropriation of profits. It is, however, an involuntary appropriation and is therefore sometimes treated as an expense and debited in the Profit and Loss Account proper; even so, it must be distinguished from other taxation on profits.)

(*d*) Provisions other than those already shown under (*a*) (12 (1) (*f*)). (The Board of Trade may exempt a company from the obligation to show an amount set aside for provisions if satisfied that disclosure is not required in the public interest and would prejudice the company, but subject to the condition that any amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact) (12 (2)).

(*e*) Amounts withdrawn from provisions and not applied for the purposes thereof (12 (1) (*f*)).

(*f*) Income from investments, distinguishing between trade investments and other investments (12 (1) (*g*)). (The gross amount before deduction of tax should be shown.)

(*g*) Remuneration (including expenses) of the auditors if not fixed in general meeting (13).

(*h*) Directors' remuneration, etc. (S. 196). (The various sub-headings required here have been considered already.)

(2) Matters which are normally stated in the Appropriation Account after the profit or loss for the year has been determined and before the final balance is carried into the Balance Sheet.

(*a*) United Kingdom Income Tax (12 (1) (*c*)). (But see Note under 1 (*c*) above.)

(*b*) Redemption of share capital (12 (1) (*d*)). (This refers to the amount transferred to Capital Redemption Reserve Fund when Redeemable Preference shares are redeemed out of profits.)

(*c*) Redemption of loans (12 (1) (*d*)). (For example, the annual allocation to a Sinking Fund for redemption of debentures.)

(*d*) Dividends paid and proposed (12 (1) (*h*)). (The net amount after deduction of tax (except where the dividend is paid free of tax) should be shown.)

(3) Matters which are normally stated by way of a note.

(*a*) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for, or the fact that it is not provided for, as the case may be (14 (2)).

(*b*) The basis on which the charge for United Kingdom income tax is computed (14 (3)).

(*c*) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax (14 (4)).

(*d*) Comparative figures (14 (5)). (These are the corresponding amounts for the immediately preceding financial year for all items shown. This does not apply to the first account submitted after July 1, 1948,

and obviously cannot apply to the first Profit and Loss Account of a new company.)

(*e*) Any material respects in which any items shown in the Profit and Loss Account are affected—

(i) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(ii) by any change in the basis of accounting (14 (6)).

BANKING AND DISCOUNT COMPANIES

Any company which satisfies the Board of Trade that it ought to be treated for the purpose of the 8th Schedule as a banking company or as a discount company is *not* subject to the following requirements of that Schedule:

(1) As respects its Balance Sheet: paragraph 4 (except so far as it relates to fixed and current assets), paragraphs 5, 6 and 7, and sub-paragraphs 8 (1) (*d*) and 11 (8).

(2) As respects its Profit and Loss Account: paragraph 12 (except sub-paragraph 1a (*h*), and sub-paragraphs 14 (2), (3) and (6).

The requirements from which it is exempted are, in the main, those relating to provisions and reserves, and, in particular, those which strike at the old practice of creating secret or internal reserves. The creation (and, where necessary, use) of internal reserves by banking companies has long been recognized as a normal feature of banking practice.

In consequence, the joint-stock banks have been able to show, in their published accounts, a consistent record of progress and stability which has contributed very largely to the confidence with which such institutions are regarded. It is essential that a bank should enjoy the confidence of the trading public in general and of its own customers in particular. In fact, it can be said that confidence is of the very essence of the undertaking.

In times of trade depression (and to a lesser extent at other times) some of the advances made by a bank by loan or overdraft may, at the best, become frozen and, at the worst, have ultimately to be written off as irrecoverable. Very considerable internal reserves are therefore built up against possible bad debts. These are reserves rather than provisions because, when they are created, they are much in excess of the amount necessary at that time to provide for advances known to be bad or even doubtful. They are internal reserves because it is the practice, in the Balance Sheet, to include them in one total with actual liabilities.

The losses which these reserves are intended to meet may never occur, but if they do occur it will generally be at a time when confidence is already at a low level. If the published accounts of the banks had to disclose very large transfers from reserves (whether or not accompanied by a corresponding increase in provisions) at such a time, the shock to public opinion might lead to a run on the banks which would add still further to their difficulties.

The record of the English banking system, as compared with that of

some other countries, would seem to place beyond doubt the wisdom of the existing practice; hence the exemption of banking companies from many of the requirements of the 8th Schedule. It is provided, however, that "where in its Balance Sheet capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its Profit and Loss Account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at" (23 (1)).

Discount companies (that is, companies whose principal business is the discounting of bills of exchange, including Treasury bills) are included in this exemption because their functions are a specialized aspect of banking and they are an integral part of the London money market.

ASSURANCE COMPANIES

A company which is an assurance company within the meaning of the Assurance Companies Acts, 1909 to 1946, is exempt from the same requirements of the 8th Schedule as is a banking or discount company, and, in addition, certain provisions of paragraphs 8 and 11 of the Schedule do not apply to its Balance Sheets.

The main reason for this exemption is that such a company is required to submit its accounts in a particular form to the Board of Trade; the fact that such accounts have been submitted is a necessary condition of the granting of the exemption.

The exemption extends to any wholly owned subsidiary company the business of which is complementary to assurance business of the classes carried on by the assurance company.

An assurance company whose business includes to a substantial extent business other than assurance business may be required by the Board of Trade to comply with some or all of the provisions of the 8th Schedule from which it would otherwise be exempt.

GENERAL POWERS OF THE BOARD OF TRADE

Reference has already been made in several places to the power of the Board of Trade to grant exemption, *in individual cases*, from some of the requirements of the 8th Schedule. In addition, the Board of Trade is given general power by paragraph 25 of the 8th Schedule to exempt a *class of companies* from certain provisions of the Schedule, if such a course appears desirable in the national interest. The requirements in respect of which exemption may be granted are paragraph 4 (except in regard to fixed and current assets), paragraphs 5, 6, 7, and 12 (1) (*a*) (*e*) and (*f*).

HOLDING COMPANIES

A holding company is one in relation to which another company is a subsidiary. By Section 154 (1) a company is "deemed to be a subsidiary of another if, but only if: "(*a*) that other either—

"(i) is a member of it and controls the composition of its board of directors; or

"(ii) holds more than half in nominal value of its equity share capital; or

"(*b*) the first mentioned company is a subsidiary of any company which is that other's subsidiary."

For the purpose of the foregoing definition "the expression 'company' includes any body corporate, and the expression 'equity share capital' means, in relation to a company, its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution."

It will be observed that the essential feature of the definition is control. This is normally exercised by the holding of shares in the subsidiary. (The majority of subsidiary companies are, in fact, wholly-owned subsidiaries, the whole of their issued capital having either been subscribed or acquired by the holding company.) In addition, the definition extends to control exercisable by the right to appoint a majority of the directors and to indirect control exercised through a chain of companies.

Example

The issued share capital of A, Ltd., is 30,000 6 per cent Preference shares of £1 each, and 20,000 Ordinary shares of £1 each. Each share carries one vote and the directors are appointed (and subjected periodically to re-election) by the members in general meeting.

If B, Ltd., holds more than 25,000 shares in A, Ltd., of either class, then A, Ltd., will be a subsidiary of B, Ltd., because the latter is a member of it and holds sufficient voting power to control the composition of its board of directors.

Alternatively, if B, Ltd., holds more than 10,000 of the Ordinary shares in A, Ltd., then A, Ltd. is a subsidiary of B, Ltd., because the latter holds more than half the equity share capital of it. This is so even though the holding does not in fact carry control of the voting power in A, Ltd.

Further, if A, Ltd., is a subsidiary of B, Ltd., for either of the foregoing reasons and B, Ltd., is itself a subsidiary of C, Ltd., then A, Ltd., is also a subsidiary of C, Ltd.

GROUP ACCOUNTS

Where a company is a holding company because it has one or more subsidiaries, then the holding company and *all* its subsidiaries together constitute a group of companies. The owners of this group (or the principal owners where some subsidiaries have minority or "outside" shareholdings) are the shareholders in the holding company; to give them a true picture of the state of affairs group accounts are required.

Group accounts normally take the form of Consolidated Balance Sheets and Profit and Loss Accounts.

A Consolidated Balance Sheet shows the state of affairs of the group

by bringing together the relative figures from the separate Balance Sheets of the holding company and its subsidiaries. In the process of consolidation, inter-company shareholdings, loans and indebtedness are eliminated and the result approaches as nearly as possible to what the Balance Sheet of the holding company would have been if it had owned the assets and carried on the business of the subsidiaries itself.

A Consolidated Profit and Loss Account brings together the trading results of the group in one account, shows the aggregate of the provisions and reserves created out of such profits and the aggregate balance carried forward (after providing for the interest of any "outside" shareholders therein). In the process of consolidation, inter-company dividends are eliminated and the only debits for dividends paid and proposed are those which result in an actual payment either to the shareholders in the holding company or to the minority shareholders (if there are any) in the subsidiaries.

The preparation of consolidated accounts may raise problems of great difficulty, particularly where foreign subsidiaries are involved or there are complex minority or cross holdings.

HOLDING COMPANIES' ACCOUNTS

The preparation of group accounts does not relieve the holding company of the obligation to prepare its own Balance Sheet for presentation to its members. This is often known as the "legal" Balance Sheet of the holding company, since before the 1948 Act came into force it was the only Balance Sheet required by law (although Consolidated Balance Sheets were often presented by holding companies).

In the legal Balance Sheet all the usual requirements of the 8th Schedule will apply with, in addition, the following:

"The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the Balance Sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and—

(*a*) the references in Part 1 of this Schedule to the company's investments shall not include investments in its subsidiaries required by this paragraph to be separately set out; and

(*b*) paragraph 5, sub-paragraph (1) (*a*) of paragraph 12, and sub-paragraph (2) of paragraph 14 of this Schedule shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries" (15 (2)).

There are also special requirements dealing with cross-holdings (shares in a holding company held by its subsidiary; such a holding, if acquired after July 1, 1948, would usually be illegal, but the shares may have been acquired legally before that date) and with the further information that has to be given by the holding company where group accounts are not submitted.

The obligation imposed upon the directors of a company to lay accounts before the shareholders, normally (but not necessarily) at intervals of one year, is found in Section 148 of the Companies Act, 1948:

"The directors of every company shall at some date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year lay before the company in general meeting a Profit and Loss Account or, in the case of a company not trading for profit, an Income and Expenditure Account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months, or, in the case of a company carrying on business or having interests abroad, by more than twelve months." (The Board of Trade has power to extend the time limits in individual cases.)

"The directors shall cause to be made out in every calendar year, and to be laid before the company in general meeting, a Balance Sheet as at the date to which the Profit and Loss Account or the Income and Expenditure Account, as the case may be, is made up."

These requirements must be read in conjunction with those of Section 131 (already considered in Chapter XI), which govern the holding of an annual general meeting. The submission of the accounts, and of the directors' and auditors' reports thereon, is the principal reason for holding an annual general meeting of the shareholders in a company. This has to be done "once at least in every calendar year" (but not necessarily in the year during which the company was incorporated or in the following year).

Where a company makes up its accounts regularly to the same day in each successive year, little difficulty is experienced in complying with the regulations. If it is desired to change the accounting date, however, which involves the preparation of at least one Profit and Loss Account that covers an odd period of more or less than one year, both sections of the Act must be watched carefully.

Example (*a*)

A, Ltd., was incorporated on October 1, 1949. By Section 148 its first Profit and Loss Account can be made up to a date not later than April 1, 1951 (that is, 18 months after the date of incorporation). By Section 131, however, although there need be no annual general meeting in the years 1949 or 1950, the first such meeting must be held not later than April 1, 1951 (that is, 18 months after the date of incorporation). The accounts have to be sent out with the notice of the meeting.

Thus, the latest date that can, in fact, be chosen for the company's first Balance Sheet is one which will allow sufficient time for the preparation, audit and sending out of the accounts on March 10, 1951, giving 21 days' notice of a meeting to be held on April 1, 1951. (If *all* the shareholders agree, the 21 days' notice can be waived.)

Example (b)

A, Ltd., in fact, made up its first accounts to September 30, 1950, and held its first annual general meeting on December 1, 1950. The directors then decided that the work of stocktaking would be eased if the company's financial year ended on December 31.

If the second Profit and Loss Account were to be made up for the period of 15 months from October 1, 1950, to December 31, 1951, it would not be possible to lay it before the company in general meeting during the year 1951. This would infringe Section 148 (which refers to the date on which an account is to be submitted rather than the date to which it is made up) as well as Section 131.

Thus, to change the accounting date from September 30 to December 31 will necessitate the preparation of one Profit and Loss Account covering the short period of three months ending December 31, 1950. These accounts can then be submitted to the members at any time up to September 30, 1951 (or three months later if the company has interests abroad).

BOOKS OF ACCOUNT

It is provided by Section 147 that:

"(1) Every company shall cause to be kept proper books of account with respect to—

(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company.

"(2) For the purposes of the foregoing subsection, proper books of account shall not be deemed to be kept with respect to the matters aforesaid if there are not kept such books as are necessary to give a true and fair view of the state of the company's affairs, and to explain its transactions.

"(3) The books of account shall be kept at the registered office of the company or at such other place as the directors think fit and shall at all times be open to inspection by the directors."

Some of the books may be kept at places outside Great Britain but returns must then be made at intervals of not more than six months such as will enable the annual accounts to be prepared in compliance with the Act.

SUBMISSION OF ACCOUNTS

Although the accounts are formally submitted to the members at the annual general meeting of the company, copies have to be sent out before the meeting.

The following persons:

(1) every member of the company;

(2) every holder of debentures in the company; and

(3) any other person who is entitled to receive notices of annual general meetings of the company,

are entitled to have sent to them, not less than 21 days before the date of the meeting, "a copy of every Balance Sheet, including every document required by law to be annexed thereto, which is to be laid before a company in general meeting, together with a copy of the auditors' report . . ." (S. 158).

There are, however, the following exceptions:

(1) The accounts need not be sent to members or debenture holders who are not entitled to receive notices of meetings *and* of whose addresses the company is not aware (for example, holders of share warrants to bearer). It may be noted that where the company is aware of the address of a shareholder or debenture holder, it must send him a copy of the accounts even though, under the Articles of the company, he is not entitled to receive notices of meetings.

(2) In the case of joint holdings (that is, a holding of shares or debentures registered in the joint names of two or more persons; for example, shares held by trustees under a will) only one of the joint holders need be regarded as a member for this purpose, unless more than one is entitled to receive notices of meetings.

(3) If the accounts are sent less than 21 days before the date of the meeting, they shall, notwithstanding that fact, be deemed to have been duly sent if it is so agreed by all the members entitled to attend and vote at the meeting. This is a necessary corollary to the provisions which enable the meeting to be called at short notice. It may be noted that the consent of debenture holders and of persons (other than members) who are entitled to receive notices of meetings is not required.

COPIES OF ACCOUNTS

Section 158 also provides that "any member of a company, whether he is or is not entitled to have sent to him copies of the company's Balance Sheets, and any holder of debentures of the company whether he is or is not so entitled, shall be entitled to be furnished on demand without charge with a copy of the last Balance Sheet of the company, including every document required by law to be annexed thereto, together with a copy of the auditors' report on the Balance Sheet."

This provision is complementary to the one which requires the company to send out copies of the accounts before calling the meeting. It enables a new holder of shares or debentures to require a copy of the accounts submitted to the last preceding annual general meeting, before he was a member or debenture holder. It also enables all joint holders to require copies of accounts even though they are not entitled to have them sent without such a demand.

RESPONSIBILITY OF DIRECTORS FOR ACCOUNTS

If a director of a company fails to take all reasonable steps—

(1) to comply with the provisions of Section 147 in regard to the keeping of proper books of account;

(2) to comply with the provisions of Section 148 in regard to the submission of accounts at an annual general meeting;

(3) to comply with the provisions of Section 149, the 8th Schedule and any other provisions of the Act regarding the matters to be stated in the accounts,

he shall, in respect of each offence, be liable on summary conviction to imprisonment for a term not exceeding six months or to a fine not exceeding £200; provided that—

(1) in any proceedings against a person in respect of an offence under these sections, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and reliable person was charged with the duty of seeing that the provisions were complied with and was in a position to discharge that duty; and

(2) a person shall not be sentenced to imprisonment for such an offence unless, in the opinion of the court dealing with the case, the offence was committed wilfully.

It is not the duty of the auditor, as such, to prepare the accounts or to send them out to the persons who are entitled to receive them, so the fact that a "competent and reliable person" has been appointed auditor of the company would not be likely, in itself, to excuse the directors if a breach of the provisions occurred. The auditor of a private company, however, is often instructed to act also as accountant to the company, to prepare the annual accounts and to advise on secretarial matters. In such circumstances a director who acts reasonably and is not wilfully a party to any breach of these provisions of the Act is likely to be excused.

APPOINTMENT OF AUDITORS

As the primary duty of a company's auditors is to report to the members of the company on the accounts examined, it is natural to find that the power to appoint auditors is normally vested in the members.

By Section 159 (1) "every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that to the conclusion of the next, annual general meeting."

Where, as is usual, the retiring auditor is to be reappointed, it is not necessary to have a resolution to that effect passed by the meeting. If such a resolution is not proposed or adopted, then by Section 159 (2), the retiring auditor is automatically reappointed without any resolution being passed, unless—

(1) he is not qualified for reappointment; or

(2) a resolution has been passed at that meeting appointing somebody to replace him or providing expressly that he shall not be reappointed; or

(3) he has given the company notice in writing of his unwillingness to be reappointed; or

(4) notice had been given of an intention to nominate some other person but by reason of the death, incapacity or disqualification of that person the resolution cannot be proceeded with.

It is clear from the foregoing exceptions to the rule of automatic re-appointment that a company may, in certain circumstances, find itself without an auditor. If this happens, the company must within one week

give notice to the Board of Trade, who may appoint a person to fill the vacancy.

The first auditor cannot very well be appointed by the members in general meeting, for he is normally required to act before that meeting. The power to appoint the first auditor is, therefore, given to the directors, and an auditor so appointed holds office until the conclusion of the first annual meeting, when he may be either expressly or automatically re-appointed by the members.

The directors also have the power to fill a casual vacancy in the office of auditor. This might arise, for example, where the auditor appointed at one annual general meeting dies before the next one. The directors cannot legally make an appointment where no auditor is appointed by the members in annual general meeting, for the right to do so is then vested solely in the Board of Trade.

QUALIFICATIONS OF AUDITORS

Except in regard to an exempt private company, a person may not be appointed as auditor of a company unless:

(1) he is a member of a body of accountants established in the United Kingdom and for the time being recognized for this purpose by the Board of Trade; or

(2) he is for the time being authorized by the Board of Trade to be so appointed, either as having similar qualifications obtained outside the United Kingdom or as having obtained adequate knowledge and experience in the course of his employment by a member of a body of accountants required for the purposes of the foregoing paragraph, or as having before August 6, 1947, practised in Great Britain as an accountant.

An officer or servant of the company may never be appointed its auditor, neither may one company (or any other form of body corporate) be appointed as auditor of another company. These disqualifications are absolute; they apply to exempt private companies as well as others. In addition, the disqualification is extended to any person who is a partner of, or in the employment of, an officer or servant of the company, but this does not apply to exempt private companies.

DUTIES OF AUDITORS

The principal duty of a company's auditors is to make a report to the members on the annual accounts. This report has to be read before the company in general meeting and is open to inspection by any member. It also has to be sent, with the accounts, to all the members of the company and all holders of debentures in it.

The following matters must be expressly stated in the auditors' report:

(1) Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

(2) Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books (and whether proper returns adequate for the purposes of

their audit have been received from branches not visited by them).

(3) Whether the company's Balance Sheet and Profit and Loss Account are in agreement with the books of account and returns.

(4) Whether, in their opinion and to the best of their information, and according to the explanation given them, the said accounts give the information required by the Act in the manner so required and give a true and fair view—

(*a*) in the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial year; and

(*b*) in the case of the Profit and Loss Account, of the profit or loss for the financial year;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the 8th Schedule are not required to be disclosed.

There are also further duties in regard to group accounts, where applicable.

Supplementary duties arise under various provisions of the Act. The auditors of a public company, for example, may be required to give a report on the profits and assets of the company for insertion in a prospectus; they are also required to certify part of the statutory report.

To enable an auditor to discharge his duties he is given a right of access at all times to the books and accounts and vouchers of the company, and is entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of his duties. He is also entitled to attend any general meeting of the company and must be given notice of all such meetings. He is entitled to address the meeting (at his own discretion) on any business which concerns him as auditor.

REMUNERATION OF AUDITORS

The remuneration of the auditors of a company is fixed by the body by whom he is appointed. Where, as is usual, the appointment (or re-appointment) is being made by the members at an annual general meeting, it is not essential that the actual amount of the fee should be fixed in advance—it may be fixed "in such manner as the company in general meeting may determine." This procedure makes it possible for the fee to be fixed after the work of the audit (or most of it) has been performed, so that it may be based on the time spent by the auditors and their staff.

Whenever the actual amount of the auditors' remuneration has not been fixed by the company in general meeting, however, it must be shown separately in the Profit and Loss Account. For this purpose, any sums paid by the company in respect of the auditors' expenses are deemed to be included in the expression "remuneration."

REMOVAL OF AUDITORS

The provisions of the Act regarding the removal of auditors from office are designed to ensure that an auditor who has been conscientious in the performance of his duties (and has thus, perhaps, made enemies

within the company) shall not be removed by a "snap" resolution at the next annual general meeting.

Thus, any resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be reappointed, requires *special notice*. On receipt of such a notice the company must send a copy forthwith to the auditor, who may then make representations in writing to the company and require a copy of such representations to be sent to all members of the company. This right is additional to his right to attend the general meeting and to speak on the resolution.

SPECIMEN BALANCE SHEETS

Below is a simple illustration of a Balance Sheet drawn up to comply with the provisions of the Companies Act, 1948. An example of group accounts appears overleaf.

BETA, LTD.

Balance Sheet as at December 31, 1949

		£			£
Authorized and Issued Capital:			Fixed Assets:	£	
10,000 £1 Ordinary shares		10,000	Leasehold Premises, at cost	20,000	
			Less Depreciation	5,000	15,000
Revenue Reserves:	£		Motor Lorries, at cost	15,000	
Taxation Reserve	5,000		*Less* Depreciation	10,000	5,000
Profit and Loss A/c	15,000	20,000			20,000
		30,000	Current Assets:		
			Stock	30,000	
			Sundry Debtors	18,000	
4 per cent Debentures (secured)		20,000	Cash at Bank	3,000	51,000
Current Liabilities and Provisions:			Discount on Debentures		2,000
Provision for Inc. Tax 1949–50	5,000				
Sundry Creditors and Accruals	18,000	23,000			
		£73,000			£73,000

Notes. (1) £5,000 4 per cent Debentures have been redeemed and are available for reissue.

(2) There is a contingent liability under guarantees given to hire-purchase finance companies, estimated to amount to £20,000.

(Comparative figures must be given unless this is the first Balance Sheet to be submitted to the members of the company after July 1, 1948. The Balance Sheet must be signed on behalf of the Board by two of the directors. The Profit and Loss Account must be annexed to it and the reports of the auditors and directors attached thereto before it is issued.)

Balance Sheet and Consolidated Balance Sheet as at January 1, 1949

	Parent Company only			Group Consolidation		
	1947	1948		*1947*	1948	
1. FIXED ASSETS—	£	£	£	£	£	£
(a) Freehold Land, Buildings and Plantations	*259,326*	247,477		*457,674*	715,197	
(b) Plant and Equipment	*38,412*	54,564		*237,705*	367,901	
(c) Trade Investments	*2,790*	7,666		*3,893*	8,769	
	300,528	309,707		*699,272*	1,091,867	
(d) Shares in Subsidiary Companies	*427,301*	747,301		—	—	
TOTAL FIXED ASSETS	*727,829*		1,057,008	*699,272*		1,091,867
2. CURRENT ASSETS—						
(a) Stock in Trade and advances on consignment as certified by the Directors	*416,880*	384,133		*1,262,586*	1,363,827	
(b) Sundry Debtors and Payments in advance, less provisions	*188,392*	195,988		*517,525*	808,478	
(c) Tax Reserve Certificates	*266,475*	110,825		*266,475*	110,825	
(d) Cash at Bankers and in hand	*250,665*	130,548		*335,206*	232,436	
	1,122,412	821,494		*2,381,792*	2,515,566	
(e) Indebtedness of Subsidiary Companies (Net)	*379,224*	376,396		—	—	
TOTAL CURRENT ASSETS	*1,501,636*	1,197,890		*2,381,792*	2,515,566	
3. CURRENT LIABILITIES & PROVISIONS—						
(a) Sundry Creditors and accrued charges	*186,294*	181,547		*435,790*	617,290	
(b) Provision for Taxation	*311,911*	265,130		*683,317*	666,754	
(c) Provision for Final Preference and Ordinary Dividends (Net)	*58,575*	48,950		*58,575*	48,950	
Total Current Liabilities	*556,780*	495,627		*1,177,682*	1,332,994	
NET CURRENT ASSETS	*944,856*		702,263	*1,204,110*		1,182,572
	1,672,685		1,759,271	*1,903,382*		2,274,439
4. DEFERRED LIABILITY—						
Reserve for Income Tax, 1949/50	*108,100*		85,000	*224,010*		318,716
TOTAL NET ASSETS	*1,564,585*		1,674,271	*1,679,372*		1,955,723

	Authorized £	*Issued & Fully Paid*					
5. CAPITAL—							
(a) 6% Cumulative Participating Preference Shares of £1 each	1,000,000	*900,000*	900,000		*900,000*	900,000	
(b) Ordinary Shares of 5s. ea.	799,997	*350,002*	350,002		*350,002*	350,002	
	1,799,997	*1,250,002*		1,250,002	*1,250,002*		1,250,002
6. CAPITAL RESERVE—							
(a) E.P.T. Post-War Refund		*136,288*		136,364	*201,075*		242,411
7. REVENUE RESERVES—							
(a) Stock Valuation Reserve		*50,000*	65,000		*100,000*	150,000	
(b) Leather (Charges) Order—Stock Reserve Depreciation Account		—	9,509		—	99,914	
(c) Profits carried forward		*128,295*	213,396		*128,295*	213,396	
Total Revenue Reserves		*178,295*		287,905	*228,295*		463,310
TOTAL OF SHARE-HOLDERS' INTERESTS		*1,564,585*		1,674,271	*1,679,372*		1,955,723

Notes on the Balance Sheet

	Parent Company: At Book Value 27 Dec., 1947, less proceeds of subsequent Sales	Parent Company: At Cost	Parent Company: TOTAL	Group Consolidation: At Book Value 27 Dec., 1947, less proceeds of subsequent Sales	Group Consolidation: At Cost	Group Consolidation: TOTAL
	£	£	£	£	£	£
Notes 1a—						
Freehold Land, Buildings and Plantations	259,326		259,326	457,674		457,674
Additions during the year		19,974	10,851		357,601	344,827
Less Sales during the year	9,123			12,774		
	250,203		270,177	444,900		802,501
Less Depreciation, year to 1st January, 1949	5,210	17,490	22,700	9,073	78,231	87,304
	244,993	2,484	247,477	435,827	279,370	715,197
Notes 1b—						
Plant and Equipment	38,412		38,412	237,705		237,705
Additions during the year		40,173	38,568		257,172	249,824
Less Sales during the year	1,605			7,348		
	36,807		76,980	230,357		487,529
Less Depreciation, year to 1st January, 1949	4,284	18,132	22,416	25,415	94,213	119,628
	32,523	22,041	54,564	204,942	162,959	367,901
Notes 1c—						
Trade Investments, at cost, 27th December, 1947			2,790			3,893
Additions during the year			5,000			5,000
			7,790			8,893
Less Sales during the year at cost			124			124
			7,666			8,769
Notes 1d—						
Shares in Subsidiary Companies, at Cost, less amounts written off to 27th December, 1947			427,301			
Increase in Issued Share Capital of The Hodgson Extract Co. (Pty.) Ltd.			320,000			
			747,301			

Note 6a—E.P.T. Post-War Refund is the amount received to date and has been wholly expended in development and re-equipment.

Generally: *1.*—The figures for 1947 have been adjusted to the basis used for 1948.

2.—The commitments for Capital Expenditure at 1st January, 1949, amount to:—
Parent Company, £31,736; Group, £228,843.

3.—The Group consolidation does not include Richard Hodgson & Sons (Canada) Limited, which has been included as a trade investment as the Company is not at present operating.

Barrow Hepburn & Gale Ltd. and Subsidiary Companies

Consolidated Profit and Loss Statement Year 1948
53 weeks ended January 1, 1949

	Paid	Proposed	1947 (52 weeks) £	1947 (52 weeks) £	1948 (53 weeks) £	1948 (53 weeks) £
Balance of Trading Profit for the Year				677,067		833,496
Add:						
Leather (Charges) Order—Rebate				—		201,847
Interest on Tax Reserve Certificates				1,188		1,464
Interest on War Damage Value Payments (Net)				4,021		12
Dividends from Trade Investments (Net)				145		151
Profit on Realization of Trade Investment				—		210
				£682,421		1,037,180
Deduct:						
Depreciation—						
Freehold Land, Buildings and Plantations			10,330		37,304	
Plant and Equipment			32,183	42,513	94,628	131,932
Remuneration of Directors of Barrow Hepburn & Gale Limited from Parent and Subsidiary Companies—						
Directors' Fees			2,500		2,500	
Other Emoluments			41,350	43,850	50,495	52,995
Auditors' Fees and Expenses—						
Parent Company			500		600	
Subsidiary Companies			1,313	1,813	1,666	2,266
War Damage Contribution arising from War Damage Value Payments				1,034		6
Taxation on the Profits for the Year—						
Profits Tax			82,791		112,890	
Income Tax			234,214	317,005	342,051	454,941
Additional Provision for Taxation on Profits of previous years				—		1,975
Leather (Charges) Order—Stock Reserve Depreciation Account				—		99,914
				£406,215		744,029
Balance of Net Profit for the Year				276,206		293,151
Balance Brought Forward from last year				110,139		128,295
Surplus from Reserve for Taxation at end of previous year				55,000		—
				441,345		421,446
Appropriations made and proposed:						
Additional Depreciation—						
Freehold Land, Buildings and Plantations			10,000		50,000	
Plant and Equipment			20,000		25,000	
Amount applied to extinguish the excess of Book Value of shares in Subsidiary Companies over their surplus assets			100,000		—	
Stock Valuation Reserve			100,000		50,000	
Dividends in respect of the year 1948 after deducting income tax at 9s. in the £:	*Paid*	*Proposed*				
6% Cumulative Participating Preference Shares:						
Interim 3% Actual	£14,850					
Final 6% Actual		£29,700				
Ordinary Shares—						
Interim 10% Actual	19,250					
Final 10% Actual		19,250				
	34,100	48,950	83,050	313,050	83,050	208,050
Balance Carried Forward				128,295		£213,396

Notes. (1) The Balance Sheet and Accounts which appear on the preceding three pages are excellent examples of the modern trend in presenting the annual accounts of large public companies. As the company is a holding company, its own assets include a substantial amount (£747,301) for "Shares in Subsidiary Companies." It is therefore necessary, in order to comply with Section 150 of the Companies Act, 1948, to present "Group accounts" in addition to the Balance Sheet of the parent company. These take the usual form of Consolidated Balance Sheet and Profit and Loss Account.

(2) The arrangement of the two Balance Sheets, including the comparative figures required by the Act, in the form of a Statement of Total Net Assets enables them to be set out on one page and thus facilitates the comparison of the figures. This arrangement is made possible only by giving much of the detailed information required by the Act in the form of Notes on a separate page. The Balance Sheets themselves give all the salient figures in the total but are not over-complicated by the inclusion of a mass of detail.

(3) Current Liabilities and Provisions are shown as deductions from the Current Assets, the balance being carried out as Net Current Assets. The expression Working Capital is sometimes used to describe this balance. Subject to the deduction of the reserve for "future income tax" (which is here treated as a deferred liability rather than as a reserve in the strict sense of that term), the addition of these figures to the totals of the Fixed Assets then shows the Total Net Assets. The bottom half of the Balance Sheets then shows how these totals are represented by the Share Capital and Reserves and are, in fact, the total interests of the shareholders in the company based, of course, on the book values of the assets.

(4) Comparison of the items 7(*c*) in the Balance Sheets for the profits carried forward shows that the figures for the parent company only and in the group consolidation are the same. This indicates that the whole of the profits of the subsidiary companies are taken into the parent company's books and, that being so, Section 149 (5) applies and a Consolidated Profit and Loss Account only is required.

(5) In the printed accounts issued to shareholders the comparative figures are printed in red ink, which helps to avoid confusion between the two sets of figures.

(6) The accounts are accompanied by the Notice of the Annual General Meeting, the Directors' Report and the Report of the Auditors. There is also a printed version of the Chairman's Statement, so that those shareholders who are unable to attend the meeting are placed in possession of all the information that will be available to those who are able to attend.

(The Balance Sheets and Profit and Loss Statement of Messrs. Barrow Hepburn & Gale, Ltd., are reproduced by kind permission of that Company.)

QUESTIONS AND EXERCISES

(Key to answers on page 571)

(1) The following items are among those appearing on the draft Balance Sheet of a limited company:

	£
Freehold Buildings, at cost	25,000
Plant and Machinery, at cost, less depreciation (including estimated normal depreciation for the current year)	14,500
Stock-in-Trade, at cost	18,250

The directors ascertain that (as at the date of the Balance Sheet) the market value of the buildings is £28,000, of the plant and machinery £12,000, and of the stock-in-trade £17,980.

State, giving your reasons carefully in each case, whether for the purpose of the final accounts you consider it (*a*) advisable, or (*b*) necessary, to make any further adjustments of each or any of the figures in question.

(*R.S.A. Stage III*).

(2) State briefly what are the differences between Capital Reserves and Revenue Reserves. Give two examples of each type of reserve and state how they may arise. (*Chartered Accountants, Inter.*).

(3) How must the following be dealt with in the published accounts of a limited company: (*a*) Directors' remuneration; (*b*) Loans to officers; (*c*) Auditors' remuneration?

(4) A company was registered with a nominal capital of £250,000 in shares of £1 each. Of these, 150,000 shares were issued and were fully paid. The market value of the shares on June 30, 1948, was 50s. Out of an available balance of £56,000 on Profit and Loss Account it was decided to pay a cash dividend of 10 per cent (less income tax at 9s. in the £) and to transfer £5,000 to General Reserve. It was also decided to provide £5,000 for the liability to Profits Tax.

Set out the company's Appropriation Account to show these decisions. How would you deal with the proposed dividend on the company's Balance Sheet? (*Inst. of Bkprs. Fellow*).

(5) Charlton, Ltd., is a manufacturing company preparing accounts annually to December 31. Depreciation in respect of all plant and machinery is provided at the rate of 10 per cent per annum on original cost and is calculated by reference to the number of months during which each machine is in use; for the purpose of this question all purchases and sales are to be treated as having taken place in each case on June 30 in the years in question.

The company has been formed on January 1, 1944, and the following is an analysis of the Plant and Machinery Account from the commencement up to the time of preparation of the Trial Balance as on December 31, 1947:

	1944	1945		1946	1947
	£	£		£	£
Book value, Jan. 1		14,250		28,710	29,395
Additions during year	15,000	16,800		4,700	3,400
	15,000	31,050		33,410	32,795
Proceeds of sale, 1946 (cost in 1944, £800)			530		
Loss on same, written off			110		
				640	
Proceeds of sale, 1947 (cost in 1944, £1,000)					730
	15,000	31,050		32,770	32,065
Depreciation written off	750	2,340		3,375	
Book value, December 31	£14,250	£28,710		£29,395	

You are required:

(*a*) To compute the cost of the plant owned as on December 31, 1946;

(*b*) To calculate the depreciation to be provided in respect of 1947; and

(*c*) To set out the material information in the company's Balance Sheet as on December 31, 1947, in such a way as to disclose:

(i) The cost of plant on hand on December 31, 1946;

(ii) The net additions during 1947, at cost;

(iii) The total plant on hand on December 31, 1947, at cost;

(iv) The aggregate depreciation provided up to December, 1946, in respect of plant on hand on December 31, 1947; and

(v) The depreciation provided in respect of such plant in 1947.

(*Chartered Accountants, Inter.*).

(6) The books of I. M. Porter, Limited, General Importers, showed the following balances as at March 31, 1948; from these details and those given below prepare final accounts for the year and Balance Sheet at that date:

	£		£
Cash at Bank and in Hand	5,370	Capital authorized and issued in £1 shares fully paid	100,000
Taxation	10,000	Creditors	6,580
Purchases	166,800	Bills Payable	7,620
Stocks, March 31, 1947	24,300	Profit and Loss credit balance, March 31, 1947	1,780
Landing Charges	2,950	Discounts	450
Packing Expenses	8,600	Allowances	250
Customs Duties	11,330	Sales	283,650
Freight	9,500	General Reserve	5,000
Marine Insurance	1,550	Reserve for Taxation	5,000
Salaries	13,580		
Lease of Warehouse, cost	12,000		
Rent of Warehouse	3,500		
Rent of Offices	5,600		
Advertising	4,850		
Warehouse Expenses	13,450		
Office Expenses	8,680		
Legal Charges	250		
Formation Expenses	9,000		
Travellers' Salaries	9,240		
Travellers' Expenses	6,750		
Buyers' Expenses	2,250		
Discounts	280		
Bank Charges	450		
General Insurance	350		
Bills Receivable	6,150		
Goodwill, at cost	50,000		
Furniture and Fittings, cost	6,000		
Sundry Debtors	17,550		
	£410,330		£410,330

Henry Irven, included in Sundry Debtors for £500, has filed his petition and it is expected that his estate will realize 5s. in the £; he was also the acceptor of a bill of exchange for £500, due on May 31, 1948, which was discounted with the bank on March 1, 1948, for £490.

Stocks in the warehouse and in transit at March 31, 1948, are valued at £26,200. Bills discounted but not matured at March 31, 1948, amounted to £8,900. Purchases include £800 for goods lost at sea; this amount was recovered from underwriters in April, 1948.

One-third of the Formation Expenses should be written off; 20 per cent of the Net Profits should be transferred to General Reserve. Depreciate Furniture and Fittings by 20 per cent. Write off £2,000 per annum as amortization of the warehouse lease.

(*Inst. of Bkprs. Fellow*).

(7) M, Ltd., has an issued capital of £170,000, divided into 50,000 5 per cent Cumulative Preference shares of £1 each and 1,200,000 Ordinary shares of 2s. each, all fully paid. Accounts are prepared annually to September 30 and the preference dividend is paid half-yearly on March 31 and September 30. Hitherto all dividends paid or received have been shown "gross" in the published accounts.

The Profit and Loss Account for the year ended September 30, 1948, was first drafted in the following form:

Credit Side

	£
By Balance from last year	17,593
Net Trading Profit for the current year, including dividends and interest receivable and after charging depreciation and directors' fees	27,597
	£45,190

Debit Side

	£
To Preference Dividend paid for the year	2,500
Final Dividend paid on Ordinary shares for the year to September 30, 1947, at 3d. per share	15,000
Interim Dividend paid on Ordinary shares at 1d. per share	5,000
Provision for Taxation	1,400
Balance carried forward	21,290
	£45,190

The provision here made for taxation was sufficient to cover the company's estimated liability for Profits Tax for the current year and the whole of the agreed income tax liability for 1948–49.

On considering the draft accounts the directors decided:

(*a*) To re-arrange the figures so as to disclose separately the gross dividend, £5,000 received from N, Ltd., a subsidiary company (included net in the profit shown in the draft), remuneration of the directors of M, Ltd., £1,500, and depreciation of fixed assets, £4,500.

(*b*) To alter the existing practice so as to show all dividends payable for current and future years (but not for the past year) net.

(*c*) To transfer £2,000 to General Reserve and to increase the provision for taxation by £5,000, representing a proportion of the income tax liability for 1949–50.

(*d*) To make provision in the accounts for a proposed final dividend on the ordinary shares of 4d. per share, less tax.

You are required to set out the Profit and Loss Account, redrafted so as to give effect to the above decisions, in a form suitable for publication to the members, and to reconcile this balance now shown as carried forward with the balance shown by the original draft.

(The standard rate of income tax for 1947/48 and 1948/49 was 9s. in the £.)

(*Chartered Accountants*, *Inter*.).

(8) The Blankshire Mercury, Limited, was registered with a nominal capital of £120,000, divided into 50,000 6 per cent Preference shares of £1 each, 60,000 Ordinary shares of £1 each and 10,000 Deferred shares of £1 each, to purchase an old-established country newspaper as on January 1, 1948.

The purchase consideration was cash and, in addition, the whole of the Deferred shares were issued to the vendor, as fully paid, as the purchase price of the goodwill. All the Preference shares were issued, fully called, and paid up.

40,196 of the Ordinary shares were applied for and allotted, and 15s. per share had been called up and paid up with the exception of a call of 5s. per share on 1,200 shares. Of the Ordinary shares, 4,000 had been paid up in full.

On July 1, 1948, 5 per cent debentures for £30,000 secured by a charge on the freehold works were issued at 98 and fully paid up. Interest due on these debentures at December 31, 1948, had not been paid and no entry had been passed through the books.

In addition to the ledger accounts representing the above transactions, the following balances were extracted from the books of the company on December 31, 1948:

	£
Machinery and Plant at cost	14,850
Monotype Machines at cost	8,000
Freehold Works at cost	62,000
Preliminary Expenses	3,000
Sales	23,123
Advertisement Revenue	25,673
Jobbing Printing Receipts	1,974
Printers' and Compositors' Wages	16,324
Office Furniture	860
Sundry Debtors	8,260
Sundry Creditors	1,242
Purchases: Paper, Ink, etc.	7,968
Sales Returns	761
Management and Office Salaries	3,768
Office Expenses	197
Advertisement Canvassers' Commission	1,123
Discount Account, Debit balance	101
Printing Works Expenses	1,784
Carriage Outwards	274
Bad Debts	88
Bad Debt Reserve, January 1, 1948	250
Light and Fuel (Works £992, Office £64)	1,056
Rates, Taxes and Insurance (Works £436, Office £89)	525
Machinery Repairs	536
Paid for Literary Contributions	365
Stock of Type, January 1, 1948	11,896
New type purchased during the year	1,148
Stock of paper, ink, etc., January 1, 1948	8,927
Directors' Fees	500
Balance at Bank	7,735
Cash in Hand	463

You are required to prepare Trading and Profit and Loss Accounts for the year ended December 31, 1948, and a Balance Sheet as on that date, taking into consideration the following:

(*a*) Depreciation to be provided as follows: Machinery and Plant 10 per cent per annum, Monotype Machines 15 per cent per annum, and Office Furniture 5 per cent per annum.

(*b*) £104 paid to an injured workman and included in Printers' and Compositors' Wages is recoverable from an insurance company.

(*c*) Stock of Paper, Ink, etc., on December 31, 1948, was valued at £9,100 and Stock of Type on the same date was valued at £12,300.

(*d*) The Reserve for Bad Debts is to be increased to 5 per cent on the Sundry Debtors.

(*e*) £2,103 of Advertisement Revenue represents unexpired prepaid advertisements and is to be carried forward.

(*f*) One-third of the Debenture Discount, and one-fifth of the Preliminary Expenses, are to be written off.

(*g*) No provision has been made in respect of one year's interest at 5 per cent on the calls paid in advance. (*Chartered Accountants, Inter.*).

(9) The K Copper Mining Company, Limited, was registered on January 1, 1949, with a nominal capital of £100,000, divided into 200,000 Ordinary shares of 10s. each, to work mining concessions for which £60,000 was paid. The whole of the capital was issued and 7s. 6d. per share had been paid up on December 31, 1949. One shareholder had paid in full for his holding of 3,200 shares.

On July 1, 1949, the company issued 200 6 per cent Debentures of £100 each at 103, the issue being fully subscribed and paid up.

During the year 1949 a deposit of karonium was discovered on the property and the directors decided to treat all the expenditure thereon as capital expenditure pending development.

In addition to the accounts necessary to record the above particulars, the following balances were extracted from the books on December 31, 1949:

	£
Buildings at cost	8,520
Loose Tools	890
Plant and Machinery at cost	18,950
Preliminary Expenses	2,250
Workmen's Wages (Karonium £1,163)	10,945
Office Furniture	800
Carriage and Working Expenses of Railway (Karonium £810)	6,594
Salaries (Karonium £300)	4,210
Stores Used (Karonium £1,012)	4,346
Stock of Stores, December 1, 1949	3,200
Legal Expenses	356
Rates and Licences (Karonium £200)	1,431
Light Railway at cost	18,500
Bank Overdraft	4,600
Sundry Creditors	14,336
Sundry Debtors	15,610
Fuel (Karonium £760)	4,350
Sales of Ore	49,836
Office Expenses	320
Directors' Fees	2,000
Cash in Hand	642
Transfer Fees	5
Repairs	863

You are required to prepare Working and Profit and Loss Accounts for the year ended December 31, 1949, and a Balance Sheet as on that date, taking into consideration the following:

(*a*) Depreciation is to be provided as follows: 10 per cent on Machinery and Plant, 5 per cent on Office Furniture, $2\frac{1}{2}$ per cent on Buildings, 10 per cent on Light Railway.

(*b*) Loose tools were valued on December 31, 1949, at £700.

(*c*) 50 per cent of the preliminary expenses is to be written off.

(*d*) The shareholder who had paid his call in advance is entitled to 5 per cent interest thereon for nine months, but no entries had been made.

(*e*) Debenture interest due on December 31, 1949, had not been passed through the books.

(*f*) £3,000 is to be written off mining concessions.

(*g*) Karonium Development Account is to be charged with the following: £800 for use of plant and machinery, tools, etc., and £400 to cover supervision and general overhead expenses. (Income Tax to be ignored.)

(*Chartered Accountants*, *Inter*.)

CHAPTER XIV

BILLS OF EXCHANGE

THE use of bills of exchange had great advantages in the settlement of trading transactions before the growth of joint-stock banking and the cheque system. A cheque is, in fact, a particular form of bill of exchange and in regard to internal transactions within this country it has largely ousted the other forms of bills. For foreign transactions, the bill of exchange is still widely used and has many advantages.

A bill is primarily a method of settling the indebtedness of one person to another. Its principal advantages are that, in addition to constituting legal evidence of debt once it has been accepted by the debtor, it enables a definite term of credit to be extended to the debtor, while the creditor, if he does not wish or is unable to wait so long for payment, can transfer the bill to, or discount it with, a third party. Discounting means that the holder sells the bill to a third party for the face-value of the bill less an interest-charge. The latter will depend upon the length of time still to run, the prevailing interest-rate, and the estimated degree of risk involved. The discounting of commercial bills is now undertaken in the main by banks and discount houses.

DEFINITION

A bill of exchange is defined by Section 3 of the Bills of Exchange Act, 1882, as "An unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer."

This definition takes into account three distinct persons or parties to the bill, namely:

The *drawer*, that is, the person giving the order to pay, who actually prepares and signs the bill.

The *drawee*, that is, the person to whom the order to pay is given. The giving of this order does not in itself make the drawee liable to pay anything; if he agrees to be liable he does so by accepting the bill. He is then known as the *acceptor* and his original status of drawee ceases to be of any significance.

The *payee*, that is, the specified person to whom payment is to be made, unless the bill is to be payable to bearer (which is unusual). The drawer and payee may be, and frequently are, the same person, in which case the bill says "Pay me or my order."

Negotiability means transfer in a manner which makes the transferee the legal holder of the bill. A bill payable to "Bearer" is negotiated by delivery, being similar in this respect to a bank note. Most bills, as distinct from notes, are payable to "Order"; negotiation then involves both endorsement and delivery.

Negotiability has arisen from both common and statute law. The essential characteristics of a negotiable instrument are:

(1) In the event of non-payment, the holder can sue in his own name.

(2) Property, and not merely possession, passes by delivery, that is, without any need for a deed or other independent written evidence to support the transfer of title.

(3) The rights of a holder in due course (see below) are not prejudiced by any defect of title of a transferor or previous holder (even though, for example, the bill has been stolen or otherwise wrongfully obtained).

Endorsement is effected by the person who is, for the time being, entitled to receive payment of the bill (that is, in the first instance the payee and subsequently any person to whom the bill has already been endorsed) signing his name on the back of it. The endorsement can be *open*, in which case the signature appears without any qualifying words; the bill then becomes, in effect, a bearer bill. For example, a man who has not a bank account of his own may receive a crossed cheque. He endorses this by signing his name on the back of it and it can then be cashed for him by anybody who has a bank account.

Where bills of exchange are concerned, however, the endorsement is usually worded so that it merely operates to transfer the bill to a further named person, who is then an *endorsee* of the bill. He in turn can become an *endorser* by signing the bill, transferring it to a new endorsee, and so on.

Other forms of endorsement are of a restricted kind. The negotiability of a bill can be negatived by drawing it "Pay ...... only" or, where it is drawn in the more usual form "Pay ...... or order", a subsequent endorsement can say "Pay ...... only." This procedure is frequently adopted in the case of cheques by marking them "Account Payee Only"; apart from this, negotiability is perhaps the most useful feature of an ordinary bill of exchange and it is, therefore, unusual to find it negatived.

DOCUMENTARY BILLS

When a bill is drawn for the purpose of financing export of goods to another country, it may be one of a set of documents which arise specifically out of a given transaction. The legal ownership of the goods in such a case will be evidenced by the *bill of lading* under which they are shipped; this document may be sent to the shipper's representative abroad (or the bank acting on his behalf) with covering instructions specifying that the goods are to be delivered to the overseas customer against his acceptance of the accompanying bill of exchange (or sometimes against his payment of the bill, if it is drawn "at sight").

The exporter is then protected in that he does not part with legal ownership of the goods until the customer has accepted a bill in payment for them; the purchaser, on the other hand, does not assume any liability until he has had an opportunity of taking delivery of the goods. Furthermore, the exporter may be able to discount the bill even before it is accepted, for the bank or discount house which finances such a transaction will be secured by the documents of title to the goods.

A bill backed up in this way by shipping documents is known as a *documentary bill*, but this fact does not lead to any different treatment in the books of account of either party. The sale and purchase of the goods will be dealt with in the usual way (unless the goods have been sent "on consignment," when special considerations will apply—see Chapter XVI), while the drawing, accepting and, where applicable, discounting of the bill will be recorded as in any other case where there are no documents attached.

Documentary bills are commonly divided into "D/A" (Documents against Acceptance, meaning that documents of title are to be released to the drawee on acceptance of the bill) and "D/P" (Documents against Payment). In the latter case documents will be released to the drawee only when he pays the amount due. A "clean" bill is one with no documents attached, that is, as opposed to a documentary bill.

LIABILITY ON BILLS

The person primarily liable to meet a bill when it becomes due is the acceptor; if he does not do so he is said to dishonour the bill. It is, therefore, necessary to consider the rights of a holder of a dishonoured bill. He may, of course, sue the acceptor as the person primarily liable, but as the dishonouring of a bill is a very serious reflection on the credit of the person who does so, it may generally be assumed that only a person who is, for the time being, without adequate resources, would in fact dishonour his acceptance in this way.

The holder of the bill has, however, rights against other parties to it, unless he was the drawer of the bill and therefore himself the person liable on it next in order. Where the holder is the payee (as distinct from the drawer, where drawer and payee are not the same person) or an endorsee of the bill, and it is dishonoured by the acceptor, the holder can look to the drawer or any previous endorser for payment of it. A person who is called upon in this way to meet the bill, and does so, has in turn a right of action against the drawer or any previous endorser, and so on, so that the liability eventually comes back to the drawer in any case. The order of liability is, however, important because the drawer and possibly some of the endorsers of a bill that has passed through many hands may themselves be unable to meet their liability.

The foregoing rules are varied to a certain extent in the following circumstances:

(1) An endorsement can be made *sans recours* (without recourse). The person so endorsing the bill cannot himself be made liable on it, but rights of action against the drawer or previous endorsers are not thereby affected. A transferee may, of course, refuse to accept such an endorsement.

(2) To avoid the complications arising from dishonour, especially if the bill has been negotiated before acceptance, the bill can be *accepted for honour* by some person other than the drawee named in the bill; this person will then be liable to pay the bill if the drawee refuses to accept it or, having accepted it, dishonours it when it becomes due for payment.

For book-keeping purposes the parties to a bill fall into the following categories:

(1) Persons who hold bills which will eventually be payable by some other person. From the holder's viewpoint a bill is an asset and must be recorded as such; it may be termed a *bill receivable.*

(2) Persons who have accepted bills and are, therefore, primarily liable to meet them when they mature. In these circumstances the bill is a liability and must be recorded as such; it may be referred to as a *bill payable.*

(3) Persons who have been parties to bills other than as acceptors and have since negotiated (that is, transferred) those bills to other persons, without restricting their liability by endorsing *sans recours.* Such persons may become liable to meet the bills if they are dishonoured; if they have to meet such a liability, however, they will regain possession of the bill and will normally have a right of action (for whatever it may be worth) against some other person. This possible liability is known as a *contingent liability*; it is not normally recorded as an actual liability in the books of the person in question, but the existence of such possible liabilities should be indicated by a note at the foot of any Balance Sheet that is prepared before the maturity of the bill.

The formalities to be observed when a bill is dishonoured, in order to protect the interests of the various parties, are considered on page 331.

FORM OF BILL

The following is a simple example of a bill of exchange:

Stamp 1s.	London, E.C.2. 1 April, 19—
£100 0s. 0d.	
Three months after date pay to B or order the sum of one hundred pounds, value received.	
	(*Signed*) C
To A, 12, High Street, Northtown.	

The bill will appear as above after it has been drawn by C, the drawer, but before A, the drawee, has accepted it. B is the payee. The bill will be presented to A for acceptance; if he agrees to accept he does so by writing his name across the face of the bill. The word "accepted" is usually written above this signature, to show its purpose, but this is not essential. It is also quite usual to specify in the acceptance the place at which the bill will be paid, particularly if the acceptor wishes it to be presented to his bankers for this purpose. Thus, if A accepts the above bill and wishes

it to be presented for payment to his bankers, it will appear as follows after he has accepted it:

> Stamp
> 1s.
>
> London, E.C.2.
> 1 April, 19—
>
> **£100 0s. 0d.**
>
> *Accepted, payable at Mercantile Bank, Northtown (Signed) A*
>
> Three months after date pay to B or order the sum of one hundred pounds, value received.
>
> (*Signed*) C
>
> To A,
> 12, High Street, Northtown.

A is now the acceptor of the bill and is liable to pay £100 to the person who presents it for payment on the due date (July 4, 19—, see page 330). C will send the bill to B, the person who on the face of it is entitled to receive payment (or B may have presented it for acceptance in the first place, in which case it will already be in his possession). If B endorses the bill to D and D in turn endorses it to E, the following entries (endorsements) will appear on the back of the bill.

> *Pay D or order*
> *(signed) B*
>
> *Pay E or order*
> *(signed) D*

E is now the *holder in due course*. This term is defined by Section 29 of the 1882 Act as "a holder who has taken the bill, complete and regular in the face of it, under the following conditions, namely:

(1) that he became the holder of it before it was overdue and without notice that it had been previously dishonoured, if such was the fact;

(2) that he took the bill in good faith and for value, and that at the time the bill was negotiated to him he had no notice of any defect in the title of the person who negotiated it."

Such a holder's title is not prejudiced by any defects of title of previous holders and he may enforce payment against any party liable on the bill.

Unless E in turn endorses the bill to someone else, he will hold it until July 4 (see page 330) and then present it to A for payment. If A fails to pay, E can look to any of the other parties—that is, to C as drawer or to B or D as prior endorsers—to make good A's default. As E presumably took the bill from D in respect of some debt due or becoming due from D to him, he will probably look to D for reimbursement. D, having made good E's loss, would then look to B, from whom he obtained the bill, and B in turn will look to C.

Distinction is made between inland bills and foreign bills. From the commercial viewpoint the distinction is mainly important as affecting (1) the rate of stamp duty, and (2) the procedure to be followed in cases of dishonour. Section 4 of the Bills of Exchange Act, 1882, defines an inland bill as "one which purports on the face of it to be both drawn and payable within the British Isles, or to be drawn within them on some person resident therein. Any other bill is a foreign bill."

STAMP DUTY ON BILLS

The normal scale of stamp duty in respect of inland bills is as follows:

Where the amount does not exceed £10		2d.
Where it exceeds £10 but does not exceed	£25	3d.
” ” ” £25 ” ” ” ”	£50	6d.
” ” ” £50 ” ” ” ”	£75	9d.
” ” ” £75 ” ” ” ”	£100	1s.

For every further £100 or part of £100, a further 1s.

Bills payable on demand or at sight, or within three days after date or sight, are liable to a fixed duty of 2d. only, however large they may be in value.

Foreign bills are, with one exception now to be noted, liable to stamp duty at the same rates as inland bills. In respect of foreign bills both drawn and expressed to be payable outside the United Kingdom, but actually paid, endorsed or in any way negotiated within the United Kingdom, if the amount exceeds £50 the following reduced scale applies:

Where it exceeds £50 but does not exceed £100	6d.

For every further £100 or part of £100, an additional 6d.

The fixed stamp duty of 2d. on a bill payable on demand or the *ad valorem* duty on a foreign bill can be paid by affixing adhesive stamps to the bill, the stamp to be cancelled by the first person who signs the bill in this country. In all other cases the bill must be stamped with an impressed stamp before it is executed. Stamped "bill paper" can be obtained for this purpose.

BILLS IN A SET

Owing to the possibility of loss in transit, it has long been customary to draw in duplicate or, less usually, triplicate, and dispatch separately, bills payable abroad. The drawee will, of course, accept only the first copy presented to him, and when the bill is issued only the original will be stamped. Each bill in the set will, of course, be signed by the drawer.

Example

First of exchange:

U.K. Bill Stamp 2s.	**£150 0s. 0d.**	London, 22 August, 19—

Three months after date pay to the order of Bank of South Africa, Ltd., this FIRST OF EXCHANGE (second of exchange being unpaid) for One Hundred and Fifty Pounds, value received.

(*Signed*) R. White

To L. Black,
1224, Long Street,
Durban, S. Africa.

Second of exchange:

No U.K. Bill Stamp	**£150 0s. 0d.**	London, 22 August, 19—

Three months after date pay to the order of Bank of South Africa, Ltd., this SECOND OF EXCHANGE (first of exchange being unpaid) for One Hundred and Fifty Pounds, value received.

(*Signed*) R. White

To L. Black,
1224, Long Street,
Durban, S. Africa.

Where only one bill is issued (instead of a set) a common wording is "this SOLE OF EXCHANGE" instead of "first of exchange" or "second of exchange," as the case may be.

When a foreign bill is being handed to a bank for collection (that is, to be sent to the bank's local office for presentation for payment) or for negotiation (that is, for discounting by the bank) the bank's name will normally in each case be inserted in the bill as payee.

CALCULATION OF DUE DATE

A bill which is not payable on demand must be payable at some "fixed or determinable future time." This future time is normally expressed as so many days or months "after date" (that is, after the date on which the bill was drawn) or "after sight" (that is, after the date on which it was

accepted). The due date is then found by adding to the period of time mentioned in the bill *three days of grace*. Thus, the specimen shown on page 326 will fall due for payment not on July 1, as might be supposed, but on July 4, which is three days later. In respect of bills due for payment within the British Isles the days of grace are added in every case except where:

(1) The bill is payable on demand. This includes a bill expressed as payable at sight or on presentation.

(2) The bill itself provides otherwise; for example, by specifying payment on a particular date or after a particular time "fixed" or "certain."

If the bill is payable at so many *days* after date, the normal rules for counting days are observed. The time of payment is determined by excluding the day from which the time is to begin to run and by including the day of payment. For example, a bill drawn on July 4 and payable 90 days after date will fall due according to the following calculation:

Excluding the date of the bill, the remaining days in July number	27
Number of days in August	31
Number of days in September	30
	88

The 90 days, therefore, expire two days after September 30, that is on October 2, and the addition of the days of grace fixes the due date on October 5.

If expressed in *months*, the term months means calendar months, as in the first example.

The due date when calculated according to the foregoing rules may fall on a day upon which business is not normally conducted, such as a Sunday. The following rules laid down in the Bills of Exchange Act, 1882 (Section 14), are then observed:

"(*a*) Where the last day of grace falls on Sunday, Christmas Day, Good Friday or a day appointed by Royal proclamation as a public feast or thanksgiving day, the bill is, except in the case hereinafter provided for, due and payable on the preceding business day;

"(*b*) When the last day of grace is a bank holiday (other than Christmas Day or Good Friday) under the Bank Holidays Act, 1871, and Acts amending or extending it, or when the last day of grace is a Sunday and the second day of grace is a Bank Holiday, the bill is due and payable on the succeeding business day."

Thus, for example, a bill drawn at three months on September 25 will fall due for payment on December 28 unless that day happens to be Sunday, when it will be payable on the preceding day, December 27. If, however, it had been drawn on September 24 and the due date, December 27, is a Sunday, then the bill will not be payable until December 28, for in that case the day preceding December 27 was Boxing Day, a bank holiday.

DISCOUNTING BILLS

A creditor who draws a bill upon his debtor (generally for the value of goods supplied to the latter) does so for two reasons:

(1) A definite date of payment is fixed.

(2) By negotiating or discounting the bill the creditor can, if required, receive payment before the period has expired but the debtor retains the benefit of the full period of credit.

The concern to which the drawer of the bill turns for this accommodation is normally either a bank or a discount house (a financial institution which makes a business of dealing in bills of exchange). The charge made for this service is in the nature of interest but is known as discount because it is payable in advance as a deduction from the face value of the bill. The holder of a bill for £100 due in three months' time may be well content to take £99 now instead of waiting three months for the full amount. The person who advances the £99 will receive (or is entitled to receive) the full £100 in due course, so that he really receives £1 interest for lending £99 for three months—just over 4 per cent per annum. Expressed as discount, however, the £1 deduction from £100 is exactly 1 per cent for three months, which is 4 per cent per annum (if the calculation be made in months, which is not strictly correct).

NOTICE OF DISHONOUR

It has been seen that the holder of a dishonoured bill may have rights of action against other parties to the bill. The fact of dishonour must, therefore, be brought to the notice of any person against whom the holder has, and wishes to preserve, a right of action. The form of the notice is unimportant, but it must be given within a reasonable time. "Reasonable time" is defined as not later than is necessary to reach the party concerned on the day after the dishonour, where the persons giving and receiving the notice live in the same place, or, where they live in different places, by posting the notice on the day following the dishonour of the bill.

If it is wished to provide independent evidence of dishonour, the bill should be "protested." For this purpose the bill is re-presented to the acceptor by a notary public and on again being dishonoured that fact will be noted on the bill by the notary public. If no notary is available any substantial local resident may draw up the protest. In the case of a foreign bill, failure to have the bill protested relieves the drawer and endorsers from liability.

The protest must be signed by the notary public making it and must include a copy of the bill, a statement of the fact of presentation and dishonour, and the reason, if any, given by the acceptor for non-payment. Certain fees and expenses are payable by the person who has the bill noted and protested; these he is entitled to recover, as an addition to the amount of the bill, from the person liable thereon.

In the case of inland bills, protesting is optional except in the event of acceptance or payment for honour being desired. As already indicated, the main purpose of protesting is to secure legally acceptable evidence

of non-acceptance and/or non-payment and of the circumstances in which acceptance or payment has been refused. Particularly in the case of bankruptcy, the protesting of a bill may serve to protect the interests of the holder, but in some countries protest is not obligatory.

CHEQUES AS BILLS OF EXCHANGE

A cheque is defined as a "bill of exchange drawn on a banker, payable on demand." It is thus a negotiable instrument (see page 323) and can be endorsed from one person to another, and so on, before it is ultimately presented for payment. In fact, this characteristic of negotiability is not as a rule required, because nearly all traders have banking accounts. The great majority of cheques are drawn as a convenient method of settling indebtedness and it is intended that the payee of the cheque should pay it into his own banking account.

Negotiability is then only necessary to the extent that, the payee having put an open endorsement on the cheque by signing his name on the back of it, his bank (known as the collecting bank) is then the holder of the bill and in a position to present it to the drawee (the drawee being the drawer's bank and known as the paying bank). The Bankers' Clearing House normally provides the machinery for collection and, where the cheque is not met, for charging it back to the collecting bank, which will in turn debit its customer.

As negotiability is normally required only in this restricted sense, full negotiability can be restricted as a protection against loss in post, and otherwise, in the following ways:

(1) The cheque can be crossed, in which case it will be paid only to a bank (that is to say, the paying bank must not cash it across the counter). The crossing is effected by ruling two parallel lines across the face of the cheque; books of cheques are, if required, provided with printed crossings.

(2) If the name of the bank into which the cheque will be paid is known, this can be inserted in the crossing and the cheque will then only be paid to that bank.

(3) If the words "not negotiable" are added, a person who takes the cheque (in good faith) from someone who was not entitled to it will not have a better title to it than the party from whom he received it had; that is, he will not be able to sue the drawer of the cheque on it as a bill, which he might otherwise be able to do.

(4) If the words "account payee only" are added, the cheque can be paid only into a bank account bearing the name of the person in whose favour the cheque was drawn.

As a cheque is a bill payable on demand it has to bear the fixed stamp duty of 2d., and on being presented to the paying banker it is either paid or returned unpaid; it does not have to be "accepted" by the bank. For book-keeping purposes it has already been seen that cheques are regarded as equivalent to cash. The procedure for protesting dishonoured bills of exchange does not apply to cheques.

A person who holds a bill of exchange possesses an asset which is referred to as a bill receivable. The first person to possess this asset is normally the drawer of the bill; if he draws it upon one of his debtors in respect of money owing for goods supplied, he merely exchanges one asset for another, the bill receivable taking the place of the book debt.

As the person who was originally liable to pay the debt is the one now liable to meet the bill, and the discharge of the debt is conditional upon the bill being met in due course, it might be thought that no entry in the books of the drawer is really necessary. The debtor has not paid his debt; he has merely undertaken to pay it on some fixed future date.

However, the holder of the bill may not hold it to maturity. He may negotiate it (transfer it to another) or discount it (assign it to another in consideration of immediate payment of face value, less interest), which is something he could not very well do with the original debt. Further, if he does continue to hold the bill he must be reminded of its due date so that it can be presented for payment at the proper time. He should, therefore, open an account in his General Ledger called Bills Receivable Account, in which any such bills can be recorded while he continues to hold them. The prime entries will be made in the journal, unless the transactions are sufficiently numerous to warrant the use of a Bills Receivable Book (see page 343).

Example

A sold goods to B for £500 on April 1 and on the same day drew upon him a bill payable to A's order on "July 1 certain" for the same amount. The bill was held by A until it became due, when it was duly paid by B.

The sale of the goods will be recorded in A's Sales Day Book in the usual way and the £500 will be posted to the debit of B's account in the Sales Ledger. On receiving the bill from B duly accepted, A will make the following journal entry:

		£	£
April 1	Bills Receivable Dr.	500	
	To B		500
	being bill accepted by B, due on July 1 certain.		

When the £500 is received from B on July 1 it will be entered in A's Cash Book (Dr.) and posted to the credit of Bills Receivable Account. The relative entries in the ledger accounts will be:

SALES LEDGER

B

			£				£
April 1	To Goods	SDB	500	April 1	By Bill Receivable (due July 1)	J	500

GENERAL LEDGER

Bills Receivable

			£				£
April 1	To B, due July 1	J	500	July 1	By Cash	CB	500

The due date of the bill should always be noted against the original entry in Bills Receivable Account and it is preferably also noted in the personal account of the debtor. It will then always be possible to tell, at any given date, how much credit has been extended to a customer, whether in the form of bills receivable outstanding or ordinary balance on Sales Ledger account, or both.

BILLS PAYABLE

A person who accepts a bill (other than a bill payable on demand which he then pays immediately) thereby incurs a liability on what is, to him, a *bill payable*. The person who drew the bill upon him was probably someone to whom he was already indebted; it does not follow that payment will ultimately be made to that person, for the bill may be negotiated before it falls due. Further, the acceptor has to ensure, as far as possible, that he will be able to meet his obligation when it matures. He should therefore open, in his General Ledger, a Bills Payable Account in which all such liabilities will be recorded.

Example

In the circumstances outlined in the preceding example, B will record the purchase of goods from A by the usual entry in his Purchases Day Book, the £500 being credited to A's account in B's Bought Ledger. On accepting the bill, B will make the following journal entry:

		£	£
April 1	A Dr.	500	
	To Bills Payable		500
	being bill accepted in favour of A, payable July 1 certain.		

When the £500 is paid on July 1 it will be entered in B's Cash Book (Cr.) and posted to the debit of Bills Payable Account. The relative entries in the ledgers will be:

BOUGHT LEDGER

A

			£				£
April 1	To Bill Payable, due July 1	J	500	April 1	By Goods	BDB	500

GENERAL LEDGER

Bills Payable

			£				£
July 1	To Cash	CB	500	April 1	By A, due July 1	J	500

The discounting of a bill represents the sale of an asset, subject to the reservation that if the acceptor does not meet the bill when it becomes due, the drawer will ultimately be liable to meet it. The difference between the face value of the bill and the amount obtained when it is discounted is known as the discount; it is expressed as a rate per cent per annum calculated on the face value of the bill (not the net amount advanced) for the number of days unexpired, including the days of grace.

Example

X is the holder of Y's acceptance for £600 drawn on July 4 and payable at 90 days after date. On July 24 he discounted the bill with his bank, the rate of discount charged being 4 per cent per annum.

The due date of the bill, including days of grace, is October 5 and discount will, therefore, be calculated for the period July 24 to October 5, the first day being excluded and the last day included in the calculation of the number of days, which is therefore as follows:

July 25 to 31 inclusive	7 days	Total 73 days.
August 1 to 31 inclusive	31 „	
September 1 to 30 inclusive	30 „	
October 1 to 5 inclusive	5 „	

The discount will, therefore, be 4 per cent per annum on £600 for 73 days, that is:

$$£600 \times \frac{4}{100} \times \frac{73}{365} = £\frac{24}{5} = £4\ 16s.$$

The net amount received by X for the bill is, therefore, in effect, £600 − £4 16s. = £595 4s. For book-keeping purposes he should treat this as the receipt of £600 and the payment of £4 16s. This will facilitate the postings in X's books and will conform to the entries in his Bank Pass Book or Statement, where the bank will show the discount as a separate item or charge.

The entries in X's Cash Book and ledger will be as follows:

CASH BOOK

			£				£ s.
July 24	To Bills Receivable (Y's acceptance due Oct. 5 discounted)	GL	600	July 24	By Discount on Bills	GL	4 16

GENERAL LEDGER

Bills Receivable

			£				£
July 4	To Y, due Oct. 5	J	600	July 24	By Cash—discounted at 4 per cent	CB	600

			£ s.				
July 24	To Cash, re Y's acceptance	CB	4 16				

Discount on Bills Account is a nominal account; the balance on it at the end of the year (or other financial period) will be written off to Profit and Loss Account. Such discount should not be confused with cash discount allowed to customers and should always be recorded in a different account. It may, however, be combined with Interest Payable, for it is really interest under a different name.

Provided the bill is duly met by Y on October 5 no further entries will be made in X's books.

The necessary entries in Y's books will not in any way be affected by the discounting of the bill.

The original entry in Bills Receivable Account in X's books shows that the bill will not be finally disposed of until October 5. If X is preparing a Balance Sheet on, say, September 30, he should add a note at the foot: "There is a contingent liability in respect of a bill discounted, amounting to £600."

BILLS RECEIVABLE NEGOTIATED

As an alternative to discounting a bill receivable, the holder of it may negotiate it to some other person on account of his indebtedness to the latter.

Example

On November 1, R bought goods from S to the value of £800 and sold part of them to T for £700. On the same day R drew on T at two months after date for the full amount of £700. The accepted bill was returned to R on November 5, on which day he endorsed it "Pay S or order" and sent it to S, who agreed to take it in part settlement of R's debt to him. The balance due from R to S was settled by a cash payment on the same day, cash discount of 3 per cent being deducted.

The purchase and sale of goods will be recorded in R's books in the usual way, the other entries being as follows:

JOURNAL

		£	£
Nov. 1	Bills Receivable Dr. To T T's acceptance at 2 months after date, due Jan. 4	700	700
Nov. 5	S Dr. To Bills Receivable T's acceptance negotiated to S in part settlement of his account.	700	700

CASH BOOK

			Discount	Bank				Discount	Bank
								£	£
					Nov. 5	By S	BD	3	97

BOUGHT LEDGER
S

			£				£
Nov. 5	To Bill Receivable (T's acceptance due Jan. 4)	J	700	Nov. 1	By Goods	BDB	800
	Cash	CB	97				
	Discount	CB	3				
			£800				£800

SALES LEDGER
T

Nov. 1	To Goods	SDB	700	Nov. 1	By Bill Receivable, due Jan. 4	J	700

GENERAL LEDGER
Bills Receivable

			£				£
Nov. 1	To T, due Jan. 4	J	700	Nov. 5	By S	J	700

The entries in the books of S and T will be similar to those already illustrated, the bill being an ordinary bill payable from the point of view of T and a bill receivable to S.

BILLS RECEIVABLE DISHONOURED

So far as the holder of a bill is concerned, the effect of its dishonour is to make it valueless to him as a bill but to revive his right of action against the person from whom he took it (presumably for value). The bill must, therefore, be "written back" in the books.

Example (*a*)

In the example on page 333, if B had failed to meet the bill on July 1, the following further journal entry would be necessary in A's books:

		£	£
July 1	B Dr.	500	
	To Bills Receivable		500
	bill dishonoured by B		

The credit entry in Bills Receivable Account clears that account so far as this bill is concerned, while the original debit balance on B's personal account is restored. In addition, if A incurs noting charges he is entitled to debit them to B's account, which will then appear as follows:

B

			£				£
April 1	To Goods	SDB	500	April 1	By Bill Receivable due July 1	J	500
July 1	To Bill dishonoured	J	500				
	Cash—Noting Charges (say)	CB	1				

As B is clearly unable, for the time being, to pay the £501 due from him, A might agree to draw another bill for this balance plus interest at, say, 5 per cent per annum. If the tenor (the length of time to run) of the new bill is six months fixed, the interest will be calculated for that period (that is, the length of time for which payment of the original debt is being postponed) and not by reference to the tenor of the original bill.

The following additional entries will arise:

July 1	B Dr. To Interest Receivable Interest at 5 per cent per annum on £501 due from B, for 6 months.	12 10 6	12 10 6
July 1	Bills Receivable Dr. To B B's acceptance at 6 months in respect of balance due from him, plus interest as above.	513 10 6	513 10 6

The entries in B's books, following the dishonour of the first bill, will be complementary to those in A's books. After the appropriate journal entries have been made and posted, the ledger accounts involved will be as follows:

B's LEDGER

A

April 1	To Bill Payable, due July 1	J	500 0 0	April 1	By Goods	SDB	500 0 0
July 1	To Bill Payable, due Jan. 1	J	513 10 6	July 1	By Bill Payable unpaid	J	500 0 0
					Noting Charges	J	1 0 0
					Interest	J	12 10 6
			£513 10 6				£513 10 6

Bills Payable

July 1	To A (unpaid)	J	£500 0 0	April 1	By A, due July 1	J	500 0 0
				July 1	By A, due Jan. 1	J	513 10 6

Interest Payable

July 1	To A	J	12 10 6				

Sundry Expenses

July 1	To A (Noting Charges)	J	1 0 0				

Example (*b*)

In the example on page 335, where X discounted Y's acceptance at his (X's) bank, if the bill is not met by Y, the bank will immediately notify X of that fact and will debit the £600 to his account with them.

Although X received only £595 4s. when he discounted the bill, he has to make good the whole £600. The discount was the cost to X of obtaining accommodation from the bank 73 days ago; it is not affected by the dishonour of the bill.

X will credit the £600 in his Cash Book and post it to the debit of Y's account together with the noting charges, if any. Y will remain indebted to X for the debit balance on his account until such time as he pays it or it ultimately has to be written off as a bad debt. Before X takes this balance into his Balance Sheet under the heading Sundry Debtors he should consider whether it would not be advisable to create a Bad Debt Provision, if there is not one already. The dishonouring of a bill by non-payment is generally a sign of extreme financial weakness; it would, therefore, be unwise to regard the balance due from Y as one hundred per cent recoverable.

Example (*c*)

In the example on page 336, where R negotiated T's acceptance to S, if T fails to meet the bill, the necessary entries can be summarized as follows:

In S's books: Debit R £700; credit Bills Receivable £700.
In T's books: Debit Bills Payable £700; credit R.
In R's books: Debit T £700; credit S £700.

These entries illustrate the general principles involved when bills are dishonoured. Had the bill been met, T, the acceptor, would have paid the £700 to S, the holder, but as, in fact, it was not met:

(1) T's liability to R, on whose account he originally accepted the bill, is revived; and

(2) R's liability to S, conditionally discharged by the transfer of the accepted bill, is also revived.

Sometimes, by arrangement between the holder and the acceptor of a bill, the latter agrees to meet it before its due date, in consideration for which he is generally allowed to deduct a discount or rebate in respect of the unexpired period. The rate of rebate is, of course, a matter to be agreed between the parties—the acceptor cannot demand the right to meet the bill before it is due and to deduct rebate.

Example

In the example on page 333, if, one month after its acceptance by B, A agreed to accept immediate payment of it at a rebate of 4 per cent per annum, then the unexpired period is two months and the amount of rebate deducted will be:

$$£500 \times \frac{4}{100} \times \frac{2}{12} = £3\ 6s.\ 8d.$$

B will, therefore, pay to A £496 13s. 4d. in full settlement of his obligation under the bill. As £496 13s. 4d. will be the amount actually received by A and paid into his bank he will enter this sum in his Cash Book and post it to the credit of Bills Receivable Account. The rebate will be recorded by a journal entry:

May 1	Discount on Bills Dr. To Bills Receivable rebate on B's acceptance, due July 1, retired under discount at 4 per cent per annum.	3 6 8	3 6 8

ACCOMMODATION BILLS

If a bill is drawn and accepted otherwise than for value received it is said to be an Accommodation Bill. The purpose of such a bill is generally to enable one of the parties to it to raise funds by discounting it; it is, in effect, a method of borrowing money on the credit of the parties to the bill. Banks and others professionally interested in the discounting of bills will not as a rule discount an accommodation bill if they are aware of its nature.

The book-keeping rules to be observed are similar to those already considered. The acceptor of the bill has incurred a liability which he must record by crediting his Bills Payable Account; the double entry will be completed by debiting the person for whose accommodation he has accepted the bill (and who has by implication agreed to put him in funds to meet the bill at a later date).

The person who is accommodated in the first instance incurs a liability to the acceptor and a corresponding asset in the form of a bill receivable. The subsequent entries when he discounts the bill will be as in any other discounting transaction. Sometimes the bill is discounted for the accommodation of both parties, who then share the proceeds in agreed proportions. Care must then be taken to charge each party with a correct proportion of the expenses incurred.

Example

On August 1, P drew two bills of £300 each on Q, who accepted them for their mutual and equal accommodation, one bill being payable at two months and the other at four months. On August 4 P discounted both these bills at 3 per cent per annum, remitting half the proceeds to Q. When the first bill became due, P remitted £150 to Q as his proportion of the amount payable, but he failed to remit any further amount when the second bill became due.

Q met the second bill out of his own resources and drew a new bill on P at three months for the balance due from him plus interest at 5 per cent per annum.

The following journal entries illustrate the records made by each of the parties. In practice the cash transactions would not be journalized.

P's Journal

Aug. 1	Bills Receivable Dr.		600 0 0	
	To Q			600 0 0
	being two bills for £300 each, due Oct. 4 and Dec. 4, drawn on and accepted by Q for mutual accommodation.			
Aug. 4	Cash Dr.		595 10 0	
	Discount on Bills		4 10 0	
	To Bills Receivable			600 0 0
	Discounted on Q's acceptances discounted:			
	Bill due Oct. 4, £300, 2 months at 3 per cent per annum	1 10 0		
	Bill due Dec. 4, £300, 4 months at 3 per cent per annum	3 0 0		
		£4 10 0		
Aug. 4	Q Dr.		297 15 0	
	To Cash			297 15 0
	being half proceeds of discounting bills remitted to Q.			
Aug. 4	Q Dr.		2 5 0	
	To Discount on Bills			2 5 0
	being half discount chargeable to Q.			
Oct. 4	Q Dr.		150 0 0	
	To Cash			150 0 0
	Cash remitted to Q in respect of half share of bill due this day.			
Dec. 4	Q Dr.		150 0 0	
	Interest Payable		1 17 6	
	To Bills Payable			151 17 6
	being bill due March 7, accepted in respect of balance due to Q plus interest at 5 per cent per annum for 3 months.			

Aug. 1	P Dr. To Bills Payable being two bills for £300 each drawn by P and accepted for mutual accommodation, due Oct. 4 and Dec. 4.	600 0 0	600 0 0
Aug. 4	Cash Dr. Discount on Bills To P being half proceeds of discounting received from P and half share of discounting charges.	297 15 0 2 5 0	300 0 0
Oct. 4	Cash Dr. To P being cash received from P to meet his share of bill due this day.	150 0 0	150 0 0
Oct. 4	Bills Payable Dr. To Cash bill payable due this day.	300 0 0	300 0 0
Dec. 4	Bills Payable Dr. To Cash bill payable due this day.	300 0 0	300 0 0
Dec. 4	Bills Receivable Dr. To Interest Receivable P bill drawn on P, due March 7, for balance £150 due from him plus interest at 5 per cent per annum for 3 months.	151 17 6	1 17 6 150 0 0

BILL BOOKS

Where a business is of such a type that bill transactions are likely to be of frequent occurrence, a Bills Receivable Book and a Bills Payable Book may be used as books of prime entry. They serve two useful purposes:

(1) A more complete record of all the essential features of the bills, including the names of all parties thereto, is maintained.

(2) While the individual amounts of each bill are posted in detail to the personal accounts concerned, the General Ledger postings to Bills Receivable Account and Bills Payable Account respectively can be made in total once a month or at other convenient intervals.

Suitable rulings for such books, with a few specimen entries, are shown opposite. Although the use of Bill Books will make it unnecessary to journalize the entries relating to the original receipt or acceptance of a bill, exceptional transactions such as the dishonour or retiring of a bill will still call for use of the journal. The discounting of a bill receivable will be recorded entirely in the Cash Book, however.

BILLS RECEIVABLE BOOK

No.	Date received	From whom received	Drawer	Acceptor	Where payable	Date of bill	Term	Due date	Fo.	Amount	Remarks
										£	
1	Jan. 3	B	Self	B	North Bank, Ltd., Westminster.	Jan. 1	3 mths	April 4	23	500	Received April 4
2	7	F	G	H		2	30 dys	Feb. 4	18	62	Received Feb. 4
3	10	L	Self	L	South Bank, Ltd., Eastminster.	5	2 mths	Mar. 8	27	200	Dishonoured—see Journal.
										£762	

(Total for the month posted to the *debit* of Bills Receivable A/c.)

BILLS PAYABLE BOOK Sarita

No.	Date accepted	To whom given	Drawer	Payee	Where payable	Date of bill	Term	Due date	Fo.	Amount	Remarks
										£	
1	Jan. 5	X	X	X	Town Bank	Jan. 2	3 mths	April 5	19	350	Paid April 5.
2	8	X	X	Y	Town Bank	4	2 mths	Mar. 7	19	175	Paid March 7.
3	12	W	W	W	Town Bank	8	90 dys	April 11	41	500	Retired by agreement Feb. 28—see Journal.
										£1,025	

(Total for the month posted to the *credit* of Bills Payable A/c.)

Sarita

QUESTIONS AND EXERCISES

(Key to answers on page 571)

(1) "A bill of exchange is a negotiable instrument." Explain what this means and outline the advantages of negotiability to the business community.

(2) What is meant by (*a*) negotiating a bill; (*b*) discounting a bill? Can a bill be negotiated or discounted before acceptance?

(3) Enumerate the various parties to a bill of exchange and describe their relationship to one another.

(4) What are days of grace and how are they calculated? In which cases do days of grace not apply?

(5) Draw up a bill embodying the following details: Drawn in London on July 4 by A. Wilson, 12, Oxford Road, W.1, on G. King, 672, York Road, Southampton, payable to H. Thomas, accepted for payment at Barclays Bank, Ltd., Southampton, the amount being £250, and the tenor three months. What will be the stamp duty and maturity date?

(6) The balance on Bills Receivable Account in a trader's ledger on June 1 is £670 7s. 6d. A bill due on June 16 for £172 3s. is duly honoured and another bill for £128 9s. 6d. is discounted on the same day for £127 8s. Show the record of the above in the Bills Receivable Account. (*L. C. of C. Certificate*).

(7) J. Penniless drew a bill of exchange in his own favour on December 31 at three months from that date for £1,000. It was payable at Barmids Bank, Ltd. The bill was accepted by Dunn & Sons, Ltd., in discharge of a debt due from them. Show the entries recording the transaction in the books of J. Penniless (including his Bills Receivable Book) and indicate the entries when the bill was met on maturity. (*Inst. of Bkprs., Associate*).

(8) The Old Copper Co., Ltd., owes John Pixley the sum of £600 and gives him its acceptance at six months for this amount and £15 for interest, payable December 31. The Old Copper Co., Ltd., takes up the bill on October 1 by a cash payment of £400 and a bill at three months for the balance of £215, which bill John Pixley discounts with his bankers at 4 per cent. Make the necessary entries in John Pixley's books. (*Inst. of Bkprs. Inter.*).

(9) Pass the following matters through the journal of Adam Smith in proper technical form as may be necessary. Smith does not use Bill Books and no ledger need be given.

			£	s.	d.
Feb.	9	Smith accepts Jones's draft at one month	36	8	3
	10	Bill at two months received from Brown, duly accepted by Brown	17	2	5
	11	Jones discounts Smith's acceptance at the bank	36	8	3
	12	Williams settles his debt to Smith of £50 by endorsing over to Smith the acceptance of Thompson (due March 10)	45	0	0
	13	Smith discounts this bill at his bank, discount charge £2			
Mar.	12	Smith's bank pays the bill which Jones had discounted	36	8	3
	13	Thompson's acceptance received from Williams is returned by the bank dishonoured	45	0	0

(*Inst. of Bankers, Part I*).

(10) Brown owed Smith £200 for goods supplied. On January 1 Brown gave Smith a bill at three months and agreed to pay cash to Smith for any discounting charge. Smith immediately discounted the bill at his bank at a charge of 5 per cent per annum. Brown failed to meet the bill on its due date and Smith then drew a fresh bill for a further three months, together with interest at 6 per cent from March 31. This Smith held for collection in due course, when it was met.

You are required to write up the Sales Ledger Account of Brown, the Bills Receivable Account and the entries in the Cash Book as they would appear in Smith's books. Calculate in months. (*Chartered Accountants, Inter.*).

(11) On January 1, 1949, A drew and B accepted a bill at three months for £1,000. On January 4 A discounted the bill at 6 per cent and remitted half the proceeds to B. On February 1, 1949, B drew and A accepted a bill at three months for £400. On February 4 B discounted the bill at 6 per cent and remitted half the proceeds to A. A and B agreed to share the discounts equally. At maturity, A met his acceptance but B failed to meet his, and recourse was had to A; A drew and B accepted a new bill at three months for the amount of the original bill plus interest at 5 per cent per annum.

On July 1, 1949, B became bankrupt. A first and final dividend of 10s. in the £ was paid by his trustee in bankruptcy on October 31, 1949. B obtained his discharge on December 5, 1949, and agreed to pay A the unsatisfied balance of his account; this was paid on February 10, 1950.

Write up B's account in A's books and state how you would advise A to treat the balance on the account when preparing his Balance Sheet as on December 31, 1949. Calculate in months. (*Chartered Accountants, Inter.*).

CHAPTER XV

TOTAL ACCOUNTS AND SELF-BALANCING LEDGERS

It has been seen that the simplest set of books kept according to the principles of double-entry book-keeping usually includes at least three distinct ledgers—General Ledger, Sales Ledger and Bought Ledger. The Sales Ledger contains all the personal accounts with customers of the business who are normally debtors for the unpaid balances of their accounts, while the Bought Ledger shows the balances which are due to creditors.

An account in the General Ledger which records the totals of all the entries in the Sales Ledger and, therefore, shows the total amount due from Sundry Debtors, is known as a Total Debtors Account (or, alternatively, Sales Ledger Control Account or Sales Ledger Adjustment Account). A similar account summarizing the entries in the Bought Ledger is known as a Total Creditors Account (or, alternatively, Bought Ledger Control Account or Bought Ledger Adjustment Account).

ADVANTAGES

If such Total Accounts can be kept the following advantages are secured:

(1) By taking out lists of the detailed balances on the Sales and Bought Ledgers and comparing their totals with the balances on Total Debtors Account and Total Creditors Account respectively, separate Trial Balances of the personal ledgers are obtained. The agreement of these Trial Balances proves (subject to the limitations of all Trial Balances) the arithmetical accuracy of the entries in those ledgers. It also confirms the accuracy of the balances on the Total Accounts in the General Ledger.

(2) Where the accounts in the Sales and Bought Ledgers are very numerous and it is not practicable to extract them in detail more than once or twice a year, the Total Accounts in the General Ledger will provide monthly figures of Sundry Debtors and Sundry Creditors from which monthly Balance Sheets, if required, can be prepared.

(3) The balances in the General Ledger (including the balances of the Total Accounts and of the Cash Book and Petty Cash Book) will also provide a Trial Balance the agreement of which will, subject to some limitations, prove the accuracy of the postings to the General Ledger.

(4) The effect of the foregoing is that each of the three ledgers is balanced separately. Where differences do arise, this procedure should enable them to be localized and thus reduces considerably the work of finding the differences.

(5) The division of the work between various members of the office staff

is facilitated and the system of internal check is strengthened. In other words, a dishonest employee who, if he had access to all the books, might be able to cover up his defalcations by fraudulent entries in the ledgers will have greater difficulty in doing so if he has access to one ledger only and that ledger is periodically balanced against records kept by another person.

TOTAL DEBTORS ACCOUNT

The nature of the entries in a typical Total Debtors Account can be seen by examining a Sales Ledger in detail and putting down, in skeleton form, all the entries that appear. The following result might be expected:

TOTAL DEBTORS

To Balance b/f		By Credits and Returns
Goods		Cash
Cash (Refunds, if any)		Discount
		Bad Debts, written off
		Contras to Bought Ledger
		Balance c/f

The above is by no means exhaustive. In particular, if Bills Receivable are drawn on customers they will also give rise to entries in the Total Debtors Account. Exceptionally, other entries may be found, such as debits for interest on overdue accounts. All such exceptional entries will have one thing in common; they will be the result of postings from the journal proper, as distinct from the subsidiary books of prime entry, such as the Cash Books and Day Books.

In order to decide how best to adapt the book-keeping system to facilitate the preparation of Total Accounts, the *sources* of the various postings to the Sales Ledger must be considered. They are as follows:

	Entry in Sales Ledger Account	*Source*
Debit	Balance brought forward	The Sales Ledger itself. For the purpose of opening a Total Account for the first time a list of the balances will be taken out.
	Goods	Sales Day Book
	Cash (Refunds)	Cash Book
Credit	Credits and Returns	Sales Return Book (or Returns Inwards Book)
	Cash	Cash Book
	Discount	Cash Book (debit Discount column)
	Bad Debts written off	Journal
	Contras to Bought Ledger	Journal
	Balance carried forward .	(This balances the account)

(Other entries, being of an exceptional nature, will all be posted from the journal unless a Bills Receivable Book is kept, in which case the credits in the Sales Ledger Accounts for bills drawn on debtors will be postings from the Bills Receivable Book.)

TOTAL CREDITORS ACCOUNT

A typical Total Creditors Account will be as follows:

TOTAL CREDITORS

To Credits and Returns		By Balance	b/f	
Cash		Goods		
Discount		Cash (Refunds, if any)		
Petty Cash				
Contras to Sales Ledger				
Balance c/d				

Here again there may be debits for bills payable accepted in favour of customers, and other entries of an exceptional nature arising from journal entries.

The sources of the various entries are as follows:

	Entry in Bought Ledger Account	*Source*
Credit	Balance brought forward	The Bought Ledger itself
	Goods	Purchases Day Book
	Cash (Refunds)	Cash Book
Debit	Credits and Returns	Purchases Returns Book (or Returns Outwards Book)
	Cash	Cash Book
	Discount	Cash Book (credit Discount column)
	Petty Cash	Petty Cash Book (Sundries or Bought Ledger column, provided with posting folio column)
	Contras to Sales Ledger	Journal

(If there are debits for bills payable, they will arise from postings from the Bills Payable Book, if one is kept, or otherwise from the journal, as will any other exceptional items.)

It must be noted that the balance on Total Creditors Account reflects only the total of the Bought Ledger balances. There may be other liabilities, such as creditors or provisions for accrued expenses, which are normally recorded as balances on expense or other accounts in the General Ledger. Such liabilities or accruals are normally ascertained or calculated after the Trial Balance has been prepared and constitute adjustments made in the process of converting the Trial Balance into a Balance Sheet and Trading and Profit or Loss Account. The Total Creditors Account, therefore, cannot be relied upon to show in itself the total of *all* liabilities of the business.

ADAPTING THE BOOKS

The detailed entries in the Sales Day Book and the Sales Returns Book are normally posted to the Sales Ledger only. The monthly totals, therefore, provide the figures required for posting the Total Debtors Account and no adaptation of these books of prime entry is necessary. (See, however, page 357, where each Sales Ledger is to be balanced separately.)

Date		Name	Fo.	Discount	Sales Ledger	Other Ledgers	Bank
Jan.	1	To Balance	b/f			205 6 8	205 6
	2	X & Co.	SL	2 10 0	97 10 0		
		Cash Sales	GL			13 0 0	110 10
	3	Y, Ltd.	SL		63 0 0		63 0
		Rents Received	GL			25 0 0	25 0
	6	AB	SL		21 2 10		
		CD	SL	1 3 1	45 1 11		66 4
	10	X & Co.	SL		29 3 6		
		Sale of old plant	GL			100 0 0	129 3
				£3 13 1	£255 18 3	£343 6 8	£599
				GL (*Dr.* Discount Alld. *Cr.* Total Debtors)	GL (*Cr.* Total Debtors)		

Note. For the sake of brevity only a few
Cash Book has been balanced off as
during the month.

Similarly, the monthly totals of the Purchases Day Book and the Purchases Returns Book will provide, without amendment, the credit posting for Goods and the debit posting for Credits and Returns in the Total Creditors Account.

The *Cash Book*, on the other hand, is primarily a record of cash received and paid. Cash received will usually, but not necessarily, come from debtors who have accounts in the Sales Ledger. Cash paid will include, in addition to payments to creditors who have accounts in the Bought Ledger, many items of expenditure, such as wages and rent, which are posted to the General Ledger.

Occasionally, cash may be refunded to customers or be refunded by suppliers. These latter items will usually be so few in number that they can quite easily be picked out at the end of the month. The *minimum* amount of analysis of the Cash Book necessary to facilitate the preparation of Total Accounts is, therefore, as shown in the specimen given at the top of the page.

On the debit side of the Cash Book all the amounts in the discount and Sales Ledger columns will be posted to the credit of the appropriate accounts in the Sales Ledger. The totals of these two columns must,

Date	Name	Fo.	*Discount*	*Bought Ledger*	*Other Ledgers*	*Bank*
Jan. 2	By Wages	GL			36 6 3	
	Petty Cash	PCB			10 0 0	46 6 3
3	LM & Co.	BL		105 0 0		105 0 0
	P	BL	1 10 0	48 10 0		48 10 0
	Q	BL		26 1 3		26 1 3
	R	BL		19 2 11		19 2 11
	S	BL	18 1	35 5 11		35 5 11
9	Wages	GL			37 1 2	
	Petty Cash	PCB			9 5 0	46 6 2
	Rent	GL			50 0 0	50 0 0
	Y, Ltd. (Refund)	SL			7 0 0	7 0 0
31	Balance	c/f			215 12 5	215 12 5
			£2 8 1	£234 0 1	£365 4 10	£599 4 11
			GL (*Cr.* Discount Recd. *Dr.* Total Creditors)	GL (*Dr.* Total Creditors)	GL (*Dr.* Total Debtors £7.)	

typical entries have been made, but the though these were the only transactions

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therefore, be posted to the credit of Total Debtors Account. There is also one item on the credit side of the Cash Book which gives rise to a posting to the Sales Ledger, namely, the refund of £7 to Y, Ltd. This has, therefore, to be picked out of the Other Ledgers column at the end of the month and posted to the debit of Total Debtors Account.

If such refunds are likely to occur frequently (for example, where customers are asked to make deposits, some or part of which may have to be returned), it would be better to provide an additional Sales Ledger column on the credit side of the Cash Book.

Similarly, the totals of the Discount and Bought Ledger columns on the credit side of the Cash Book will be posted to the debit of Total Creditors Account.

The *Journal* will also require adaptation unless the entries in it are so few that they can be dealt with separately (that is, each amount that has to be posted to either the Sales Ledger or the Bought Ledger is at the same time also posted to the Total Debtors Account or the Total Creditors Account respectively). It will be necessary to insist on the rule that all transfers from one account to another (except perhaps transfers between accounts in the same ledger, though even then it is desirable) are passed

Transfer Journal

Date	Particulars	Fo.	General Ledger Dr.	General Ledger Cr.	Sales Ledger Dr.	Sales Ledger Cr.	Bought Ledger Dr.	Bought Ledger Cr.
Jan. 6	AB Dr. To AB being settlement by contra.	BL SL				8 17 2	8 17 2	
8	Bills Receivable Dr. To E being E's acceptance at 3 months after date.	GL SL	100 0 0			100 0 0		
9	T Dr. To Bills Payable being T's draft accepted, payable 2 months after date.	BL GL		200 0 0			200 0 0	
10	W Dr. To Interest Receivable being interest charged to W on overdue account: 5 per cent p.a. for 3 months on £200.	SL GL		2 10 0	2 10 0			
10	Discount Receivable Dr. To S being discount disallowed.		18 1					18 1
			£100 18 1	£202 10 0	£2 10 0	£108 17 2	£208 17 2	18 1

Proof of "cross-cast":

Debits	Credits
100 18 1	202 10 0
2 10 0	108 17 2
208 17 2	18 1
£312 5 3	£312 5 3

through the journal, which for that reason is often known as a Transfer Journal. A suitable ruling is illustrated above.

The totals of the Sales Ledger and Bought Ledger columns in the journal will be posted monthly as follows:

Sales Ledger Dr.	to the *Debit* of Total Debtors Account.
Sales Ledger Cr.	to the *Credit* of Total Debtors Account.
Bought Ledger Dr.	to the *Debit* of Total Creditors Account.
Bought Ledger Cr.	to the *Credit* of Total Creditors Account.

The totals of the General Ledger columns will *not* be posted, as the double entry in the General Ledger has already been completed by posting the detailed amounts in those columns. In fact, where the personal ledgers are separately balanced by the method now being considered it may be noted that:

(1) The Bought and Sales Ledgers are, in effect, subsidiary to the General Ledger, explaining in detail the figures that appear in total in the Total Creditors and Total Debtors Accounts respectively.

(2) The double entry for every transaction, therefore, has to be completed, either in detail or in total, in the General Ledger (or in the Cash Book or Petty Cash Book which, together with the General Ledger, complete the main double-entry system and are reflected in the main Trial Balance).

It follows, therefore, that although the Day Books and Return Books (and, where they are used, the Bill Books) do not require adaptation, the following additional postings must be made in order to complete the double entry in the General Ledger (and, incidentally, as an essential step in completing the Total Accounts):

Sales Day Book	The monthly totals must be *debited* to Total Debtors Account in addition to being *credited* to Sales Account.
Sales Returns Book	The monthly totals must be *credited* to Total Debtors Account in addition to being *debited* to Returns Inwards Account.
Bought Day Book	The monthly totals (of the Amount column where a columnar book is kept) must be *credited* to Total Creditors Account. This posting balances either the posting of the same amount to the debit of Purchases Account, when the book is not a columnar one, and deals only with the record of goods purchased; or the total of the various debit postings to Purchases and other accounts in the General Ledger where a columnar book is used.
Purchases Returns Book	The monthly totals must be *debited* to Total Creditors Account, the credit postings being the reverse of those necessary in the case of the Bought Day Book.

Example

Assume that, in addition to the transactions already recorded in the Cash Book on pages 348 and 349 and the journal on page 350, the following information also applies:

(1) The balances brought forward on personal accounts on January 1 were:

Sales Ledger

X & Co.	100	0	0
AB	30	0	0
CD	46	5	0
W	200	0	0
	£376	5	0

Bought Ledger

AB	8	17	2
LM & Co.	105	0	0
P	50	0	0
Q	26	1	3
R	19	2	11
S	36	4	0
T		7	6
	£245	12	10

(2) The entries in the Day Books were:

Sales Day Book

Jan. 2	Y, Ltd.	63 0 0
7	X & Co.	29 3 6
8	E	100 0 0
10	AB	45 6 8
12	CD	21 2 10
13	X & Co.	182 10 0
		£441 3 0

Sales Return Book

Jan. 4	Y, Ltd.	7 0 0
14	X & Co.	32 10 0
		£39 10 0

Bought Day Book

Date	*Name*	*Fo.*	*Amount*	*Purchases*	*Carriage*	*(Other columns as required)*
Jan. 2	LM & Co.		60 0 0	60 0 0		
3	Br. Rlys.		15 10 0		15 10 0	
4	Q		113 6 8	113 6 8		
9	T		200 0 0	200 0 0		
			£388 16 8	£373 6 8	£15 10 0	

Purchases Returns Book

Jan. 4	LM & Co.		10 0 0	10 0 0		
6	Q		5 0 0	5 0 0		
			£15 0 0	£15 0 0		

(3) The balance of 7s. 6d. due to T on January 1 was paid on January 6 from Petty Cash.

Given the foregoing balances and entries, the Total Accounts and Ledger Accounts will appear as follows:

(1) The Total Accounts in the General Ledger will be written up thus:

TOTAL DEBTORS

Jan. 1	To Balance b/f	376 5 0	Jan. 31	By Returns	39 10 0
31	Sales	441 3 0		Cash	255 18 3
	Cash (Refund)	7 0 0		Discount	3 13 1
	Journal	2 10 0		Journal	108 17 2
				Balance c/d	418 19 6
		£826 18 0			£826 18 0
Feb. 1	To Balance b/d	418 19 6			

Total Creditors

		£	s.	d.			£	s.	d.
Jan. 31	To Returns	15	0	0	Jan. 1	By Balance b/f	245	12	10
	Cash	234	0	1	31	Purchases	388	16	8
	Discount	2	8	1		Journal		18	1
	Petty Cash		7	6					
	Journal	208	17	2					
	Balance c/d	174	14	9					
		£635	7	7			£635	7	7
					Feb. 1	By Balance b/d	174	14	9

(2) The following balances will appear in the Sales Ledger and Bought Ledger respectively on January 31:

Sales Ledger	£	s.	d.	*Bought Ledger*	£	s.	d.
X & Co.	150	0	0	LM & Co.	50	0	0
AB	45	6	8	Q	108	6	8
CD	21	2	10	S		18	1
W	202	10	0	Br. Rlys.	15	10	0
	£418	19	6		£174	14	9

The entries in the personal accounts will appear as shown in outline below:

Sales Ledger

X & Co.

B/f	100	0	0	Cash & Dis.	100	0	0
Goods	29	3	6	Cash	29	3	6
Goods	182	10	0	Returns	32	10	0
				C/d	150	0	0
	£311	13	6		£311	13	6
B/d	150	0	0				

AB

B/f	30	0	0	Cash	21	2	10
Goods	45	6	8	Contra	8	17	2
				C/d	45	6	8
	£75	6	8		£75	6	8
B/d	45	6	8				

W

B/f	200	0	0				
Interest	2	10	0				
	£202	10	0				

CD

B/f	46	5	0	Cash & Dis.	46	5	0
Goods	21	2	10	C/d	21	2	10
	£67	7	10		£67	7	10
B/d	21	2	10				

Y

Goods	63	0	0	Cash	63	0	0
Cash	7	0	0	Returns	7	0	0
	£70	0	0		£70	0	0

E

Goods	100	0	0	Bill Receiv.	100	0	0

Bought Ledger

AB

Contra	8 17 2	B/f	8 17 2

P

Cash & Dis.	50 0 0	B/f	50 0 0

LM & Co.

Cash	105 0 0	B/f	105 0 0
Returns	10 0 0	Goods	60 0 0
C/d	50 0 0		
	£165 0 0		£165 0 0
		B/d	50 0 0

Q

Cash	26 1 3	B/f	26 1 3
Returns	5 0 0	Goods	113 6 8
C/d	108 6 8		
	£139 7 11		£139 7 11
		B/d	108 6 8

S

Cash & Dis.	36 4 0	B/f	36 4 0
C/d	18 1	Discount	18 1
	£37 2 1		£37 2 1
		B/d	18 1

T

PC	7 6	B/f	7 6
B/P	200 0 0	Goods	200 0 0
	£200 7 6		£200 7 6

R

Cash	19 2 11	B/f	19 2 11

Br. Rlys.

		Carriage	15 10 0

The agreement of these totals with the balances carried down on the Total Debtors and Total Creditors Accounts respectively constitutes the separate Trial Balances of the personal ledgers. It still remains to balance the General Ledger, which will be done by extracting all the balances on that ledger, including the balances on the two Total Accounts, listing them on journal-ruled paper in the usual way. The inclusion of the Cash Book and Petty Cash Book balances should cause the totals to agree. If they do not agree, then the fact that the personal ledgers have already been balanced will minimize considerably the burden of locating the difference.

EFFECT OF ERRORS

As one of the main objects of keeping Total Accounts is to enable the various ledgers to be balanced separately and to enable differences, when they arise, to be localized, it is necessary to consider the effect of various types of error upon the agreement of the several Trial Balances.

Arithmetical errors or errors of commission may arise in casts (additions), postings or the extraction and listing of balances. They may be reflected by differences on a Total Account (when its balance is compared with the detailed schedule of balances of the ledger which it represents) or on the main Trial Balance, or on both. The following examples are all based on the foregoing example.

Example (*a*)

If the Sales Day Book had been added up incorrectly, the total being entered as £431 3s. 0d. instead of £441 3s. 0d., and then posted to the General Ledger (Dr. Total Debtors Account, Cr. Sales Account):

(i) The main Trial Balance will still agree, as the same (incorrect) figure has been debited and credited in it. In other words, so far as the General Ledger is concerned, there is a compensating error.

(ii) The balance of the Total Debtors Account will be reduced to £408 19s. 6d., but the detailed Sales Ledger balances will still show the correct total of £418 19s. 6d.

The existence of an error is thus revealed by the disagreement of what may be regarded as the Sales Ledger Trial Balance. This does not mean that it is necessarily in the Sales Ledger but it does show that it arises from one of the book-keeping processes connected with the detailed transactions that are recorded in the Sales Ledger.

Example (*b*)

If the sale to CD on January 12 had been entered correctly in the Day Book (£21 2s. 10d.) but had been posted to CD's account in the Sales Ledger as £2 12s. 10d.:

(i) The main Trial Balance will agree and in this case the figures in it will be correct.

(ii) CD's account will show a balance of £2 12s. 10d. only, which will be included in the schedule of Sales Ledger balances, the total of which will, therefore, be £400 9s. 6d. as compared with the balance of £418 19s. 6d. on Total Debtors Account.

In this case, therefore, the error is in the Sales Ledger and its existence is revealed by the Trial Balance of that ledger.

Example (*c*)

If the total of the Sales Day Book (£441 3s.) had been posted correctly to the debit of Total Debtors Account, but incorrectly, as £441 13s., to the credit of Sales Account:

(i) There will be a difference of 10s. on the main Trial Balance.

(ii) The Sales Ledger Trial Balance will agree.

In this case the error is in the General Ledger and is revealed by the main Trial Balance.

Example (*d*)

If the Sales Day Book total had been posted correctly to Sales Account but incorrectly (as £441 13s.) to Total Debtors Account:

(i) There will be a difference of 10s. on the main Trial Balance.

(ii) There will be a similar (opposite) difference of 10s. on the Sales Ledger Trial Balance.

In other words, the main Trial Balance would agree if the detailed Sales Ledger balances were substituted for the balance on Total Debtors Account. This is conclusive proof that the error is in the Total Account.

Example (*e*)

If the book-keeper had posted the 7s. 6d. paid to T from the Petty Cash Book to T's account in the Bought Ledger, but had omitted to post it to the debit of Total Creditors Account in the General Ledger:

(i) There will be a difference of 7s. 6d. on the main Trial Balance, because to that extent the double entry has not been completed in the General Ledger.

(ii) There will be a similar (opposite) difference of 7s. 6d. on the Bought Ledger Trial Balance.

Again the "equal and opposite" differences prove that the error is in the Total Account.

Example (f)

If the balance on Q's account in the Bought Ledger had been incorrectly listed as £108 16s. 8d., either through an error in adding up the two sides of the account or in extracting the balance:

(i) The main Trial Balance will agree.

(ii) There will be a difference of 10s. on the Bought Ledger Trial Balance.

RULES FOR LOCATING ERRORS

From the foregoing examples can be built up the following general rules:

(1) When the main Trial Balance agrees but there is a difference in balancing a personal ledger, the difference may be due to:

(*a*) An error in the additions of one of the books of prime entry from which postings are made to that personal ledger.

Note. This includes the appropriate Discount column in the Cash Book. It would also include an error in the appropriate Cash column, but this should be revealed by the reconciliation of the Cash Book with the Bank Pass Book or Statement *and* the agreement of the cross-cast of the Cash Book totals.

(*b*) An error in posting to one of the accounts in the personal ledger.

(*c*) An error in balancing one of the accounts in the personal ledger or in extracting those balances on to the Trial Balance.

(2) When the Trial Balances of the personal ledgers agree but there is a difference on the main Trial Balance, the difference must be due to an error in posting to or extracting balances from the General Ledger (or the Cash Book balance, if not reconciled with the bank balance). It should, therefore, be unnecessary to check any of the additions in the books of prime entry or the postings to the personal ledgers or the extraction of the balances from those ledgers.

(3) When equal and opposite differences arise on the main Trial Balance and on either the Bought or Sales Ledger Trial Balance, then the error must be in the Total Account, which disagrees with its own balances.

LIMITATIONS OF SELF-BALANCING

All Trial Balances are subject to some limitations, and the system of self-balancing ledgers, which is really a division of the one Trial Balance into several, is no exception to this rule. Thus, no system, however thoroughly carried out, will in itself detect:

(1) The complete omission of a transaction from the books. (For example, if the sale of £21 2s. 10d. to CD had not been entered in the Day Book it would not have been posted to any ledger and no difference would have arisen.)

(2) An error of principle. (For example, if the purchase from T, £200, had in fact been the cost of new plant but the transaction was treated as an ordinary purchase.)

(3) A posting to the wrong account unless the two accounts concerned are in different ledgers.

(4) Compensating errors, where they are in the same ledger or, in certain cases, where they are in different ledgers.

Thus, self-balancing ledgers cannot, in themselves, prevent errors, nor will they always detect them. In most circumstances they will prove of great assistance in the detection of errors by localizing them to one section of the books. The best safeguard against book-keeping errors is, in the long run, care and accuracy on the part of the book-keeper.

SECTIONAL BALANCING

Where the size of the business is such that more than one Sales Ledger has to be kept, the process of self-balancing can be extended to each of the Sales Ledgers. This is of great assistance in locating errors when they do arise and is a useful feature of the office organization or "internal check."

Where bound ledgers are not kept, the personal accounts being in the form of cards (for instance, where ledger-posting machines are used), each batch of cards kept by one book-keeper or machine operator may constitute a separate section for the purpose of self-balancing. Similar principles can be applied on the Bought Ledger side where more than one Bought Ledger is kept.

Sectional balancing obviously calls for further adaptation of the books of prime entry, so that monthly totals are available for posting to each of the separate Total Accounts that will be kept. Where the number of sections or ledgers is not unduly large the provision of additional analysis columns will probably suffice.

Example

In a business which involves the keeping of four Sales Ledgers and two Bought Ledgers, appropriate rulings of the Day Books would be as follows:

SALES DAY BOOK

Date	*Name*	*Fo.*	*Amount*	*A to H*	*I to M*	*N to S*	*T to Z*

All amounts will be entered twice—once in the Amount column and again in the appropriate Ledger column. At the end of the month the

four Ledger columns will cross-cast and equal the Amount column.

The Amount column will be *credited* to Sales Account in the General Ledger, while the total of each Ledger column will be *debited* to the appropriate Total Account.

BOUGHT DAY BOOK

Date	*Name*	*Fo.*	*Amount*	*Bought Ledgers*		*General Ledgers*		
				A to M	*N to Z*	*Purchases*	*Carriage*	*etc.*

(This is an adaptation of the form of Day Book described on page 45 and used for recording certain "expenses" and items of capital expenditure in addition to ordinary purchases.)

All amounts will be entered three times—once in the Amount column, again in the appropriate Bought Ledger column and finally in the appropriate General Ledger column.

At the end of the month the total of the Amount column will be agreed with the cross-casts of (1) the two Bought Ledger columns and (2) the General Ledger column, including the final Sundries column.

The total of the Amount column will not be posted.

Each Bought Ledger column will be posted in total to the credit of the appropriate Bought Ledger Total Account.

Each General Ledger column, except that for Sundries, will be debited in total to the appropriate account in the General Ledger. The individual items in the Sundries column will be debited to the appropriate account in the General Ledger.

In the Cash Book it will be necessary to provide separate Cash and Discount columns for each ledger that is to be balanced separately. The Cash Book may, therefore, tend to become unwieldy if more than, say, four ledgers are involved on each side. This disadvantage can be partly overcome, however, by keeping separate books for Cash Received and Cash Paid respectively, the totals of which are transferred periodically to a General Cash Book, in which the actual balances of cash at bank will thus be recorded.

This system has the further advantage that it enables different clerks to write up and post from its respective parts. Those cash (cheque) payments which do not involve postings to the Bought Ledger can be entered directly into the General Cash Book; as some of these items will be of a private nature, the General Cash Book will then usually be kept by the chief cashier personally.

There is, however, a limit to the number of analysis columns that can be provided in any book of account. It may be noted also that the use of too many columns tends to inaccuracy, by amounts being extended into

the wrong column and to difficulty in reading off figures appropriate to the various transactions when the horizontal lines have to be taken across a very wide page.

Where, therefore, very many different ledgers are involved it is necessary to resort to some other method. Systems of machine accounting (see Chapter XXI) will, of course, be particularly suitable in such cases. If, however, bound books, written up by hand, are to be used, and there are, say, forty Sales Ledgers each of which is to be balanced separately, then the following system may be recommended:

(1) The books will be adapted for self-balancing as though there were only one Sales Ledger. There will, therefore, be one Total Debtors Account only in the General Ledger.

(2) Separate Total or Control Accounts for each of the Sales Ledgers will be opened in a Sales Ledger Summary Book.

(3) When posting any item from a book of prime entry to a Sales Ledger, care will be taken to indicate clearly the number or other reference of the ledger as well as the page in that ledger to which the amount is posted.

(4) After the books of prime entry have been completed, totalled and posted for the month, the individual amounts will be analysed either on sheets of abstract or analysis paper or by listing them on an adding machine, the total amount posted from that book to each of the forty Sales Ledgers thus being ascertained.

(5) The forty sub-totals for each book having been agreed in total with the total of the entries in that book for that month, they will then be entered in the appropriate accounts in the Summary Book, which will be under the control of the accountant or other responsible official.

(6) The book-keeper in charge of each ledger will take out a list of the balances in it at the end of the month and the accountant will compare the total of each list with the appropriate account in the Summary Book.

(7) Appropriate steps will be taken to find any difference.

TOTAL ACCOUNTS IN PERSONAL LEDGERS

When it is desired to adhere strictly to the principles of double entry it will be necessary to bear in mind that:

(1) The Total Accounts in the General Ledger are part of the double entry in that ledger and, therefore, not in the personal ledger concerned.

(2) The personal ledger (say, for the purpose of illustration, the Sales Ledger) cannot be said to balance strictly unless it also contains a Total Account, which will be called the General Ledger Control Account and is the reverse or "reflection" of the Total Debtors Account in the General Ledger.

If such an account is included in the Sales Ledger involved in the example on page 351 it will be as follows:

General Ledger Control Account

		£ s. d.			£ s. d.
Jan. 31	To Returns	39 10 0	Jan. 1	By Balance b/f	376 5 0
	Cash	255 18 3	31	Sales	441 3 0
	Discount	3 13 1		Cash (Refund)	7 0 0
	Journal	108 17 2		Journal	2 10 0
	Balance c/d	418 19 6			
		£826 18 0			£826 18 0
			Feb. 1	By Balance b/d	418 19 6

The list of Sales Ledger balances will then constitute a Trial Balance in itself, without reference to the Total Debtors Account in the General Ledger, namely:

Sales Ledger Trial Balance at January 31

	Dr.	Cr.
X & Co.	150 0 0	
AB	45 6 8	
CD	21 2 10	
W	202 10 0	
General Ledger Control A/c		418 19 6
	£418 19 6	£418 19 6

This extension of the system may be desirable from the point of view of strict book-keeping theory. It may be noted, however, that the internal check is strengthened where the ledger keeper has to show that his ledger balances against a Total Account which is kept by someone else, and to which he has not access.

CREDIT BALANCES IN SALES LEDGER

Although the balances on Sales Ledger accounts are normally debits, representing amounts owing by Sundry Debtors for goods sold to them, a credit balance may occasionally arise. For example, in the account of Y, Ltd., on page 353, if the cash refund had not been made until February there would have been a *credit* balance of £7 at the end of January. Where such credit balances do arise it must be noted that the Total Debtors Account shows only the *net* total of the Sales Ledger balance, that is, the total of all the debit balances less the credit balances, if any.

The balance on the Total Account should not be inked in finally until it has been agreed with the detailed schedule of balances. If this schedule shows both a debit and a credit total (the Total Account agreeing with the difference between these two figures) these same totals should be carried down as separate debit and credit balances respectively, on the Total Account.

Similar considerations apply when debit balances arise in the Bought Ledger.

QUESTIONS AND EXERCISES

(Key to answers on page 571)

(1) From the following prepare Bought and Sales Ledger Control Accounts as they would appear in the General Ledger of the business:

			£
Jan.	1	Balances in Bought Ledger	1,213
		„ „ Sales Ledger	2,260
Dec.	31	Total Sales	28,928
		„ Purchases	12,945
		Sales Returns and Allowances	296
		Purchases Returns and Allowances	96
		Discount Received	248
		„ Allowed	905
		Cash paid to Creditors	12,982
		„ received from Debtors	27,363
		Transfers from Debtors' to Creditors' Accounts	262

(*R.S.A. Stage II*).

(2) The following information relates to the Bought Ledger of J. Faithful, Ltd., for the month of September:

	£
Credit Balances, August 31	15,782
Cash Paid	12,164
Discounts Received	327
Purchases	13,376
Returns Outwards	642
Payments from Petty Cash	18
Bills Payable Accepted	1,100
Transfer to Credit of Sales Ledger Accounts	273
Journal Entries: Debit	486
Credit	269
Cash Received	32
Debit Balances in Bought Ledger, September 30	68

You are asked to write up the Bought Ledger Control (or Adjustment) Account for the month of September, as it would appear in the General Ledger of the company. (*Chartered Accountants, Inter.*).

(3) The following particulars, extracted from the usual books of original entry, etc., relate to the Sales Ledger transactions of Henry Smith & Co. for the month of May:

	£	s.	d.
Balances, April 30 (agreed with control):			
Debit	632	1	6
Credit	11	3	6
Sales	519	15	9
Sales Returns	7	8	3
Cash Received	467	0	9
Discounts Allowed	21	6	3
Bad Debts written off	4	15	0
Cash Refunds	3	7	0
Items in Sales Ledger transferred to debit of Bought Ledger Accounts	7	18	0
Balances extracted from Sales Ledger as on May 31:			
Debit	640	8	6
Credit	4	6	0

You are required (*a*) to construct a Sales Ledger Control Account for the month and ascertain the amount of the difference indicated thereby, and (*b*) to indicate any circumstances that would give rise to a credit balance on a Sales Ledger Account. (*Chartered Accountants, Inter.*).

(4) To facilitate balancing, a retail business keeps its Sales Ledger in three sections, divided alphabetically (A-G, H-N and O-Z), each being self-balancing. Discounts are allowed. Give, with specimen entries, the ruling you would recommend for the receipts side of the Cash Book. (*L.C. of C. Higher*).

(5) The books of X & Co. include three separate self-balancing ledgers, namely, Sales Ledger (Town Section), Sales Ledger (Country Section) and Bought Ledger. Give a ruling for a Transfer Journal for use with the above and insert therein entries to record the following transactions for December:

(*a*) The setting off of a balance of £17 15s. 0d. due from Salmon & Co., standing in the Sales Ledger (Country Section) against a credit balance in the same firm's name in the Bought Ledger.

(*b*) The writing off as bad of the following balances:

	£	s.	d.
N. Black (Town Section)	9	1	3
P. Matthews (Town Section)	3	8	6
R. Johnson (Country Section)	24	10	0
Blanktown Stores (Country Section)	18	7	6

(*c*) The charging to Standish & Co. (Town Section) of £1 5s. for interest on a long outstanding debt.

(*d*) The writing off to the credit of Bad Debts of an old unclaimed balance of £6 15s. standing to the credit of F. Reynolds in the Bought Ledger.

Insert the totals and state what postings would be made to the Nominal Ledger. (*L.C. of C. Higher*).

(6) Smith and Evans divide their Sales Ledger into two sections, known as A and B, each being separately balanced by means of a Control Account in the Nominal Ledger. The Sales Day Book, the journal and the receipts side of the Cash Book are all ruled analytically and the periodical totals of the columns checked by means of cross-casts, all of which agree. The Trial Balance incorporates the balances of the Control Accounts, and as on March 31 all the books were balanced.

As on April 30 it was found that the main Trial Balance and the B section both agreed but that as regards the A section the schedule of debtors was less than the control account balance by 10s.

Assuming that only one mistake has been committed, state exactly what you can infer as to its location and give a detailed list of the possible ways in which it may have been committed. (*Chartered Accountants, Inter.*).

(7) A business has its Sales Ledger alphabetically divided into three sections, A–G, H–O and P–Z, each being separately balanced by means of a Control Account in the Nominal Ledger.

State precisely what differences will appear in the respective sectional Trial Balances or in the Trial Balance of the Nominal Ledger (for which the Control Account balances are used) as the separate result of each of the following errors:

(*a*) The direct transfer of the balance of Miss Jones's Account, £6 9s. 6d., from the H–O section to the P–Z section on notice being received of her marriage to Mr. Smith.

(*b*) The misposting as £1,046 15s. 6d., both to the A–G Control Account and to the Sales Account, of the sales in the A–G section for April, totalled correctly in the Day Book as £1,045 16s. 6d.

(*c*) The misposting to the Sales Account as £843 4s. 9d. of the November sales in the P–Z section, the posting to the Control Account, £834 3s. 9d., being the correct amount. (*Chartered Accountants, Inter.*).

(8) M and N are partners, trading under the name of M & Co. The firm's ledgers consist of a Nominal Ledger, a Sales Ledger and a Bought Ledger, the last two being self-balancing. Each partner has a personal account in the Sales

Ledger to which is debited the value of goods taken by him for personal use and invoiced as sales through the Sales Day Book.

On September 30 the undermentioned matters remained to be recorded when closing the books:

(*a*) The transfer of a balance of £19 15s. standing to the debit of Ryland & Co. in the Sales Ledger to an account in the name of the same firm in the Bought Ledger.

(*b*) The writing off as bad of the following debit balances standing in the Sales Ledger:

	£	s.	d.
J. Brown	5	16	6
Gates & Co.	17	13	0
Penrith & Sons	15	0	9

(*c*) The charging to Sanders & Sons in the Sales Ledger of £1 5s. as interest on an overdue account treated by arrangement as a temporary loan.

(*d*) The charging to S. Evans, Ltd., in the Sales Ledger of 17s. 9d. excess discount originally credited in error.

(*e*) The transfers to the drawing accounts of M and N of the balances standing to the debit of their accounts in the Sales Ledger, £25 15s. and £38 7s. 6d., respectively, representing goods taken by them during the year, invoiced at cost, and any further adjustment which may be desirable in connexion therewith.

Give a ruling of a journal suitable for recording these items, and show the totals for incorporation in the Control Accounts.

(*Chartered Accountants, Inter.*).

(9) The following balances appear in the books of a business on December 31:

	£	s.	d.
Cash balance	36	7	2
Balance at Bank	754	10	8
Debtors Ledger Control Account	1,765	10	7
Creditors Ledger Control Account	974	2	8

During the month of January, the following transactions occur:

		£	s.	d.
Jan. 2	Received cheque from Debtor A	154	2	6
	Allowed discount Debtor A	1	7	6
	Received cheque from Debtor B	77	9	0
	Allowed discount Debtor B		11	0
	Paid by cheque—Creditor E	47	10	0
	,, ,, ,, ,, F	264	0	0
	Paid by cash ,, G	10	0	0
	Banked cheques received £231 11s. 6d.			
10	Paid cash—salaries	25	0	0
18	Received—cash sales	49	10	0
22	Received cheque from Debtor C after deducting contra account £50	250	0	0
	Drew cash from Bank	100	0	0
	Paid wages	123	6	4
	,, Petty Cashier	25	0	0
	Paid by cheque Creditor H	97	6	8
23	Received cheque Debtor D	7	16	6
	Allowed discount Debtor D		3	6
	Banked cheques received £257 16s. 6d.			
31	Received cash sales	57	10	6
	Banked cash	35	1	4

	£	s.	d.
Credit sales during month were	694	17	8
Returns and allowances to customers were	14	6	10
Bad Debts written off were	10	4	8
Purchases during month were	496	1	7
Credits for packages returned to creditors were	15	10	4

You are requested to write up the Cash Book and Debtors and Creditors Ledger Accounts for the month of January. (*Chartered Accountants, Inter.*).

CHAPTER XVI

CONSIGNMENTS, ACCOUNTS CURRENT AND JOINT VENTURES

CONSIGNMENTS

If goods are sent by one person to another, who is to sell them on behalf of the first person, the transaction is known as a consignment.

The person who sends the goods to be sold in this way is referred to as the consignor; the person to whom they are sent is the consignee. The legal relationship between these two persons is that of principal and agent.

The agent or consignee is normally remunerated for his services by receiving (or retaining out of the proceeds of the sale) a commission, which is generally calculated on the proceeds of sale. If the agent, in addition to selling the goods, guarantees that the proceeds of sale shall be paid to the consignor (so that the agent bears the credit risk) he may receive an additional commission for so doing; this is known as a *del credere* commission. Such an agent may be known as a *del credere* agent. It must be noted that, except where the agent undertakes to carry the risk of bad debts himself (whether or not he receives a *del credere* commission therefor), this risk falls upon the principal. The agent has carried out his part of the bargain when he sells the goods.

ACCOUNT SALES

In the process of receiving and perhaps warehousing the goods and subsequently selling them, the agent may incur expenses, which he can recover from his principal unless he has agreed to bear them himself. These expenses, together with the agent's commission, are normally deducted by the agent from the gross proceeds of sale and the balance of the proceeds is then remitted to the principal. The amount remitted is explained in a statement which sets out the details and proceeds of sale and the various deductions therefrom. This is known as an Account Sales. It usually takes the form shown on the opposite page.

Where the amount involved is substantial and there is a ready market for the goods which are being consigned, the consignor may sometimes draw a bill of exchange upon the consignee for part of the value at or about the time when the goods are dispatched and before they have been sold or, possibly, even received by the consignee. If the agent is a person or firm of standing this will enable the consignor to discount the bill and thus raise funds for the purpose of financing this and subsequent transactions.

Such a bill would normally be discounted before it has been accepted by the consignee; in such a case the documents of title to the goods (such as a Bill of Lading) would be attached to the bill, which would

AB & Co.
Capetown
April 7, 19—.

ACCOUNT SALES

of Consignment No. 302 from XY, Ltd., London, per S.S. *Flying Dutchman.*

	£ s. d.	£ s. d.
Proceeds of Sale:		
20 Bicycles, Pattern 21G, at £10 each		200 0 0
10 Bicycles, Pattern 20L, at £10 10s. each		105 0 0
		305 0 0
Deduct:		
Port Dues and Landing Charges	6 0 0	
Import Duty	30 0 0	
Warehouse Charges	4 0 0	
Commission—10 per cent on £305	30 10 0	
Del Credere—$2\frac{1}{2}$ per cent on £305	7 12 6	
Exchange and Bank Charges on Sight Draft	2 0 0	80 2 6
Net Proceeds		£224 17 6
Sight Draft on Standard Bank of South Africa, No. 97–206893		£224 17 6

(*Signed*) AB & Co.

E. and O.E.

thus become a Documentary Bill (see Chapter XIV). The documents of title will then be released to the consignee only upon his accepting the bill.

Alternatively, the agent may have opened a confirmed credit with bankers in London upon whom the bill will then be drawn. The bankers will accept the bill and will take possession of the documents as security. The bill having been so accepted becomes a first-class trade bill and it will be possible for the consignor to discount it on the most advantageous terms.

For the purpose of drawing such a bill and for other reasons (such as fixing a value for insurance purposes or to give details for the assessment of import duties) the consignor frequently draws up a pro-forma invoice in which the goods are charged to "account" of the consignee as though they had been sold to him. This pro-forma invoice may be of importance as one of the supporting documents relating to the goods, but it is not an invoice in the ordinary sense because the goods have not been actually sold, and it should *not* be recorded in the Sales Day Book of the consignor as though it were an invoice relating to an outright sale of goods.

The cost of conveying the goods from the consignor to the agent and of insuring them while in transit is normally borne by the consignor and, therefore, has no effect on the indebtedness of the one party to the other. Such expenses will have to be taken into account by the consignor in calculating his profit or loss on the consignment, however.

The two essential principles to be borne in mind when framing the entries in the consignor's books are:

(1) The transaction must not be treated as a sale until the goods have actually been sold by the consignee.

(2) The indebtedness of the consignee for goods sold, less expenses incurred and commission due to him, must be shown in a personal account opened for that purpose.

It is also desirable, but not essential, that separate records should be maintained for each consignment so that the ultimate profit or loss on it is shown.

These objects are best achieved in the following way:

(1) An account suitably headed to identify it with the consignment (for example, Consignment No. 302 to AB & Co., Capetown) is opened in the General Ledger or, if such transactions are numerous, in a special Consignments Outwards Ledger. To this account is debited:

(*a*) The cost of the goods sent on consignment, the double entry being completed in a Goods Sent on Consignment Account. The function of this latter account is to relieve the General Trading Account of the goods sent out on consignment, since the individual consignments will show the ultimate profit or loss on these transactions. While separate Consignment Accounts are opened to receive the debits in respect of each consignment, all the credit postings will be made in the one Goods Sent on Consignment Account. If the transactions are numerous, a Consignments Outwards Journal can be used, the entries in it being posted in detail to the appropriate Consignment Account and in total (say, monthly) to Goods Sent on Consignment Account. On the other hand, if the consignments are few and far between, the prime entries can be made in the journal. The Sales Day Book should *not* be used, for that would lead to the credit being taken, incorrectly, to Sales Account.

(*b*) Any expenses directly incurred in the process of sending the goods to their destination, such as carriage, insurance and freight, will also be debited to the appropriate Consignment Account, as an addition to the cost of the goods. The double entry will either be completed in the Cash Book, in cases where such expenses are paid immediately, or by an appropriate journal entry to the credit of a Bought Ledger Account in other cases.

(2) A personal account for the consignee will be opened when an Account Sales has been received from him showing that either the whole or a part of the consignment has been sold. These personal accounts can be grouped in a separate Consignees Ledger if there are likely to be many of them; otherwise they should appear in the General Ledger rather than in the Sales Ledger. From the information contained in the Account Sales the following entries will then be made:

(a) Gross proceeds of sale: *debit* Consignee's Personal Account; *credit* Consignment Account.
(b) Expenses paid by agent: *debit* Consignment Account; *credit* Consignee's Personal Account.
(c) Commission due to agent: *debit* Consignment Account; *credit* Consignee's Personal Account.

Cash received from the agent (including a sight draft, which is treated as a cheque) will, of course, be recorded as a debit in the Cash Book and posted therefrom to the credit of the consignee's account. Similarly, any Bill Receivable accepted by the agent will be credited to his account and debited to Bills Receivable Account in the usual way.

(3) As a result of the foregoing entries:

(a) The consignee's account now shows the balance, if any, due from him. Should the consignor have occasion to draw up a Balance Sheet while any of these personal account balances are still outstanding, he can either include them with his Sales Ledger balances under the heading Sundry Debtors or he can group them separately as Balances due from Agents on Account Sales, or under some other suitable heading.

(b) The Consignment Account shows on the debit side the cost of the goods and all the expenses incurred to date, including those discharged by or due to the agent. On the credit side appear the proceeds of sale. If all the goods have been sold, the balance on the account represents the profit or loss on the transaction and it will be closed by transfer either to Profit and Loss Account or to a Profits and Losses on Consignments Outwards Account (which will itself eventually be transferred to Profit and Loss Account).

If, however, the goods have not all been sold, the Consignment Account will remain open until further Account Sales are received which will enable it to be completed; if this happens before the Balance Sheet date no further problems will arise. If a Balance Sheet has to be prepared before the account can be closed, however, then the unsold goods at that date will have to be valued as "Stock of Goods on Consignment" and a debit balance of that amount carried down on the Consignment Account.

In valuing this unsold stock, the "cost" of the goods will include not only their original cost price before they were consigned but also a rateable proportion of such expenses as relate to the consignment as a whole, as distinct from expenses, such as agent's commission, which relate only to the goods that have so far been sold. The "cost" value thus calculated will, of course, be compared with the current market value of the goods and the lower of these two values will then be the correct one to adopt, both for the purpose of balancing the Consignment Account and for inclusion in the consignor's Balance Sheet as "Stock of Goods out on Consignment." When the debit balance representing stock has been carried down, the Consignment Account will then show the profit or loss on goods sold to date.

Example (*a*) (*based on the Account Sales shown on page* 365)

The cost of the goods consigned by XY, Ltd., London, to AB & Co., Capetown, on January 1, was £140. XY, Ltd., paid the following expenses: Insurance £3, Freight £10. The proceeds of sale and the agent's expenses were as shown in the Account Sales, which, with the accompanying sight draft, was received by XY, Ltd., on April 30.

The accounts in the books of XY, Ltd., directly affected by this transaction will record it in the following way:

GOODS SENT OUT ON CONSIGNMENT

			Date	Particulars	£ s. d.
			Jan. 1	By Consignment to AB & Co. (No. 302)	140 0 0

(This account will be closed by transfer to the credit of Trading Account at the end of the financial year.)

CONSIGNMENT (No. 302) TO AB & Co.

Jan. 1	To Goods	140 0 0	April 30	By AB & Co. Proceeds of sale	305 0 0
	Cash (Insurance)	3 0 0			
	Cash (Freight)	10 0 0			
April 30	AB & Co. Expenses	40 0 0			
	Commisn.	38 2 6			
	Exch. and Bank Charges	2 0 0			
	Profit and Loss on Consignments A/c	71 17 6			
		£305 0 0			£305 0 0

AB & Co.

April 30	To Proceeds of sale, Consignment No. 302	305 0 0	April 30	By Expenses re Cons. 302	40 0 0
				Exch. and Bank Charges	2 0 0
				Commissn.	38 2 6
				Cash	224 17 6
		£305 0 0			£305 0 0

The completion of the double entry in respect of all the above transactions can be illustrated in the form of journal entries. In practice, the cash transactions at least would not be journalized, and special books of prime entry (for example, a Consignments Journal) might be used for some or all of the other transactions.

JOURNAL

Jan. 1	Consignment (No. 302) to AB & Co. Dr. To Goods sent on Consignment being cost of goods sent on consignment to AB & Co.		140 0 0	140 0 0
1	Consignment (No. 302) to AB & Co. Dr. To Cash being payment of Insurance £3 and Freight £10 in connexion with the above consignment.		13 0 0	13 0 0
April 30	AB & Co. Dr. To Consignment (No. 302) to AB & Co. being gross proceeds of sale of goods sent on consignment as per Account Sales received this day.		305 0 0	305 0 0
30	Consignment (No. 302) to AB & Co. Dr. To AB & Co. being expenses defrayed by agents, £42, and their commission, £38 2s. 6d., as per Account Sales.		80 2 6	80 2 6
30	Cash (Bank) Dr. To AB & Co. being sight draft on Standard Bank of South Africa.		224 17 6	224 17 6
30	Consignment (No. 302) to AB & Co. Dr. To Profit and Loss on Consignments (or Profit and Loss Account).		71 17 6	71 17 6

Notes. (1) The sight draft received from the consignees having been drawn on the Standard Bank of South Africa's U.K. office, XY, Ltd., will pay it into their bank account as though it were a cheque; it is, therefore, not necessary to treat it as bill of exchange and record it in Bills Receivable Account.

(2) "Exchange and Bank Charges" represent the cost of converting the South African net proceeds into sterling in Capetown and remitting to the consignor in the U.K.

Example (*b*)

On July 1, P consigned to A fifty cases of goods costing £20 per case, paying the following expenses in regard thereto: Carriage to docks £20, Freight £50, Insurance £30. He invoiced A "pro-forma" at £30 per case, drawing upon him a bill, payable three months after date, for 60 per cent of the invoice price. This bill he discounted on July 4 for £885. Five of the cases were lost at sea and on August 1 £120 was recovered by P under the insurance policy.

On September 1 A sent to P an Account Sales showing that he had disposed of thirty cases for £32 per case and that he had paid import duties £135 and selling expenses £100. He was entitled to a commission of 3 per cent on the gross proceeds of sale, plus 2 per cent *del credere*. He remitted a sight draft for the balance due from him at date, taking into account a rateable proportion of the bill which he had already accepted.

P balanced his books on September 30 for the purpose of preparing a Balance Sheet on that date. The market value of the unsold cases on that date was in excess of their cost.

The necessary entries in the ledgers of P will be as follows:

P's Ledger

Consignment to A

		Cases	£			*Cases*	£
July 1	To Goods	50	1,000	Aug. 1	By Insurance claim	5	120
	Carriage		20	Sept. 1	A—Proceeds of Sale	30	960
	Freight		50	30	Stock, c/d: Goods £300	15	
	Insurance		30		Consignor's Expenses £2 per case £30		
Sept. 1	A—Import Duties on 45 cases		135		Import Duties £3 per case £45		375
	Selling Expenses		100				
	Commsn. 5 per cent on £960		48				
30	Profit and Loss A/c		72				
		50	£1,455			50	£1,455
Oct. 1	To Balance b/d	15	375				

Goods sent on Consignment

		£			£
Sept. 30	To Trading A/c	1,000	July 1	By Consignment to A	1,000

A

		£			£
Sept. 1	To Consignment A/c Proceeds of Sale	960	July 1	By Bill Receivable 60 per cent of £1,500	900
Sept. 30	Balance c/d (15/45ths of £900)	300	Sept. 1	Consignment A/c Import Duties 135 Selling Exps. 100 Commission 48	283
				Cash—Sight Draft	77
		£1,260			£1,260
			Oct. 1	By Balance b/d	300

Bills Receivable

		£			£
Sept. 1	To A	900	Sept. 4	By Cash	900

Discount on Bills

		£			£
Sept. 4	To Cash	15	Sept. 30	By Profit and Loss A/c	15

Notes. (1) The discount on the bill might alternatively be treated as one of the expenses of the consignment, but it is preferably regarded as a financial expense incurred by P and written off to his Profit and Loss Account.

(2) The use of the memorandum columns headed *Cases* in the Consignment Account is of assistance in valuing the unsold stock and for proving that all the goods have been accounted for. In a mixed consignment this would not be possible, but, as an alternative, the pro-forma invoice prices might be recorded in an inner column for the same purpose.

(3) The amount of the sight draft remitted by A is calculated as follows:

Number of cases received by A		45
Number of cases sold by A up to date		30
Proportion of bill for £900 to be deducted from Account Sales, 2/3rds =		£600
Proceeds of Sale		£960
Less Expenses	£283	
Proportion of bill as above	600	
		883
Amount of sight draft		£77

(Exchange and bank charges ignored.)

The foregoing are examples of consignments outwards. The general principles to be observed in the case of consignments inwards are the same as those which determine the correct entries in the books of the consignor. The effect of these principles when the transaction is considered from the point of view of the agent or consignee is as follows:

(1) The receipt of the goods on consignment does not constitute a purchase of them, even though they may be accompanied by a pro-forma invoice from the consignor.

(2) When the consignee ultimately sells the goods he does so as agent for the consignor. The sale must, therefore, be excluded from his Sales Day Book (which records the sales of his own goods).

(3) The proceeds of sale, for which the consignee is accountable, must be passed to the credit of a personal account for the consignor. This account will also be debited with any expenses incurred by the agent on behalf of his principal and with the commission due to the agent for selling the goods. The balance of the personal account will then represent the net liability of the agent to his principal as shown by the Account Sales which the consignee will render to the consignor and will be cleared when payment of this liability is made.

(4) The commission debited to the personal account will be credited to a nominal account called Commissions Receivable or Commissions on Consignments Inwards and will thus find its way ultimately to the Profit and Loss Account. This is the only incident of the consignment which gives rise to any profit or loss in the books of the consignee, unless he is a *del credere* agent, in which case he will have to write off to his own Profit and Loss Account any bad debts he may incur.

Example (*a*) (*based on the example on page* 368)

The whole consignment was sold by AB & Co. for cash on April 7, on which day the warehousing charges were paid. Port dues, landing charges and import duty had been paid on receipt of the consignment on March 22.

The following entries will appear in AB & Co.'s books:

AB & Co.'s Ledger

XY, Ltd., re Consignment 302

Mar. 22	To Cash Port Dues and Landing Charges	6 0 0	April 7	By Cash, Proceeds of of Sale	305 0 0
	Import Duty	30 0 0			
April 7	Cash—Warehouse Charges	4 0 0			
	Commission, 10 per cent + 2½ per cent on £305	38 2 6			
	Exchange and Bank Charges	2 0 0			
	Cash: Standard Bank of South Africa for sight draft	224 17 6			
		£305 0 0			£305 0 0

Commission Receivable

			April 7	By XY, Ltd., re Cons. 302	38 2 6

(This account will be closed at the end of AB & Co.'s financial year by transfer to Profit and Loss Account.)

The method illustrated above has the merit of simplicity and conforms to strict principle in that there is no entry in the consignor's account until some at least of his goods have been sold. If the agent wishes to balance his own books and prepare a Balance Sheet while he has any unsold consignments on hand he will have to take care not to include in his stock valuation goods which belong to consignors. With this point in view it will generally be desirable that the agent should keep memorandum stock records of goods received on consignment. These will be of assistance when he is compiling his own stock valuations and will provide a record that all goods received on consignment have ultimately been accounted for.

There are alternative methods of recording these transactions which treat the consignor as a creditor for the (pro-forma) value of the goods as soon as they are received on consignment and show the unsold balance of these goods at any time.

Example (*b*) (*based on the example on page* 370)

The consignment was received by A on August 25, when he paid the import duties and accepted the bill drawn upon him by P for the full amount, notwithstanding the non-arrival of five cases (lost at sea). Of the thirty cases disposed of by A, twenty-five were sold on August 26 to C, who paid for them on September 10, and five were sold on August 31 to D, who subsequently absconded and paid nothing. The selling expenses were paid on August 31.

A desires the transaction to be entered in his books in such a way that the unsold goods will be recorded therein. His books are balanced on October 31 before any further sales have been made.

The following journal entries show the order in which the records will be made in A's books and how the double entry is completed in each instance:

JOURNAL

			£	£
Aug. 25	Goods Received on Consignment Dr. To P being invoice value of goods received on consignment from P. As per invoice, 50 cases £1,500 Less lost at sea, 5 cases 150 Invoice value of consignment received 1,350		1,350	1,350
25	P Dr. To Bills Payable being bill drawn by P on July 1, payable 3 months after date (Oct. 4) for 60 per cent of value of goods consigned, as invoiced "pro-forma" £1,500.		900	900
25	P Dr. To Cash being import duty at £5 per case on above consignment (45 cases only received).		135	135
26	C Dr. To P being sale of 25 cases ex consignment from P.		800	800
31	D Dr. To P P Dr. To Cash being sale of 5 cases ex consignment from P and payment of selling expenses.		160 100	160 100

Sept. 1	P Dr. To Commission Receivable Cash being commission (3 per cent + 2 per cent *del credere*) on proceeds of sale and sight draft for balance per Account Sales.	125	 48 77
1	P Dr. To Goods Received on Consignment being invoice price of goods sold, 30 cases at £30 per case, written back.	900	 900
10	Cash Dr. To C being cash received in settlement.	800	 800
Oct. 4	Bills Payable Dr. To Cash being P's bill paid.	900	 900
31	Bad Debts Dr. To D being bad debt written off.	160	 160

The relative ledger entries will be as follows:

A's Ledger

Goods Received on Consignment

		£			£
Aug. 25	To P	1,350	Sept. 1	By P	900
			Oct. 31	Balance c/d	450
		£1,350			£1,350
Nov. 1	To Balance b/d	450			

P

Aug. 25	To Bill Payable	900	Aug. 25	By Goods Recd. on Cons.	1,350
	Cash (Import Duties)	135	26	C	800
31	Cash (Selling Exs.)	100	31	D	160
Sept. 1	Commission	48	Oct. 31	Balance c/d (Proportion of bill for £900).	300
	Cash (Sight Draft)	77			
	Goods Recd. on Cons.	900			
Oct. 31	Balance c/d (15 cases at £30)	450			
		£2,610			£2,610
Nov. 1	To Balance b/d	300	Nov. 1	By Balance b/d	450

Bills Payable

Oct. 4	To Cash	900	Aug. 25	By P (due Oct. 4)	900

C

Aug. 26	To Goods (ex Cons. from P)	800	Sept. 10	By Cash	800

D

Aug. 31	To Goods (ex Cons. from P)	160	Oct. 31	By Bad Debt written off	160

Bad Debts

Oct. 31	To D	160			

Commissions Receivable

			Sept. 1	By P	48

(The last two accounts, with any other entries they may contain, will be closed by transfer to Profit and Loss Account, on Oct. 31.)

It will be observed that separate debit and credit balances have been carried down on P's account. The credit balance of £450 representing the pro-forma invoice price of the fifteen cases not yet sold cancels the debit balance of a like amount on Goods Received on Consignment Account, so that neither will be reflected in A's Balance Sheet. This is correct because the goods, though still on hand, do not belong to A.

The debit balance of £300 on P's account represents the proportion (15/45ths or 1/3rd) of the original bill for £900 applicable to the part of the consignment that has not yet been sold. The sight draft remitted to P for £77, being the balance due to him in respect of the thirty cases that had been sold, took into account a rateable proportion (30/45ths or 2/3rds) of the bill; the other one-third must obviously go forward as a balance to be taken into account when the remainder of the consignment is sold and a further Account Sales is remitted to P. In A's Balance Sheet this balance will appear under the heading "Acceptance against consignments not closed" or some other suitable title.

The calculation of simple interest is a matter of arithmetic rather than of book-keeping. It is, nevertheless, an essential element in the art of book-keeping whenever the transactions that are to be recorded are, by agreement or otherwise, to carry interest.

Interest is commonly expressed at a rate per cent per annum or, in other words, the amount to be paid or accounted for in respect of the loan or use of £100 for one calendar year.

The amount on which the interest is to be calculated is known as the principal. If the principal is an amount other than £100, the interest for one year is calculated by simple proportion.

Thus, the interest on £100 for one year at 5 per cent per annum is £5. So, proportionately, the interest on £1 for one year at 5 per cent per annum is £$\frac{5}{100}$, and the interest on £400 for one year at 5 per cent per annum is £400 $\times$ $\frac{5}{100}$ = £20, and, similarly, the interest on £20 for one year at 5 per cent per annum is £20 $\times$ $\frac{5}{100}$ = £1 (the answer in each case being equivalent to the principal multiplied by the interest on £1 for one year).

Similarly, if the period of time for which interest is to be calculated is other than one year, the interest for one year is increased or reduced in proportion to the time.

Thus, the interest on £100 for one year at 5 per cent per annum is £5. So, proportionately, the interest on £100 for 3 years at 5 per cent per annum is £5 $\times$ 3 = £15, and similarly, the interest on £100 for 3 months at 5 per cent per annum is £5 $\times$ $\frac{3}{12}$ = £1 5s.

When interest is calculated in the foregoing way it is said to be simple interest.

The calculation of simple interest on an amount other than £100 for a period other than one year involves two simple proportions.

Thus, the interest on £100 for one year at 5 per cent per annum is £5, and, as before, the interest on £400 for one year at 5 per cent per annum is £400 $\times$ $\frac{5}{100}$; so, proportionately, the interest on £400 for three years at 5 per cent per annum is £400 $\times$ $\frac{5}{100}$ $\times$ $\frac{3}{1}$ = £60; and, again, where less than one year is involved, the interest on £400 for two months at 5 per cent per annum is £400 $\times$ $\frac{5}{100}$ $\times$ $\frac{2}{12}$ = £3 6s. 8d.

Every calculation of simple interest is thus seen to involve three factors:

(1) The amount, or principal, on which interest is to be calculated.

(2) The rate of interest, usually expressed as a percentage (but for the purpose of calculation reduced to the rate per unit, by dividing it by £100).

(3) The period of time for which interest is to be calculated, expressed either as a number of years or as a fraction of one year.

It will often be found that, where interest has to be calculated in respect of a number of different transactions, one or possibly two of the three factors will be common to all of them. When it is desired to calculate interest at the same rate per cent for the same period of time on a number of different amounts, and only the total amount of interest is required to be shown, it will be found by adding together the various principal sums and making one calculation of interest upon their total.

Example

X lent £200 to A, £600 to B and £800 to C, in each case for six months at 4 per cent per annum. If separate calculations are made:

The interest on A's loan is	£200 × $\frac{4}{100}$ × $\frac{6}{12}$ =	£4
,, ,, ,, B's ,, ,,	£600 × $\frac{4}{100}$ × $\frac{6}{12}$ =	£12
,, ,, ,, C's ,, ,,	£800 × $\frac{4}{100}$ × $\frac{6}{12}$ =	£16
	Total	£32

If it is only desired to know the total amount of interest receivable by X in respect of the three loans, then:

The total amount advanced to A, B and C was £1,600
Interest on £1,600 for 6 months at 4 per cent per annum =
£1,600 × $\frac{4}{100}$ × $\frac{6}{12}$ = £32.

PRODUCTS

When only one of the three factors—the rate of interest—is constant and it is desired to make one calculation of the total interest upon a number of different transactions, the different amounts of principal and the time for which each is to carry interest must first be reduced to a common basis.

Thus, when it was shown that interest on £400 for three years at 5 per cent per annum is £400 × $\frac{5}{100}$ × 3, the expression is seen to be the same as £(400 × 3) × $\frac{5}{100}$ = £1,200 × $\frac{5}{100}$, or, as should be obvious, the interest on £400 for three years is the same as the interest on £1,200 for one year. Similarly, interest on £500 for two years is the same as interest on £1,000 for one year, and so on. Hence, by multiplying each amount by the time for which interest on it is to run, the resulting "products," although different in amount, all relate to the same period of time. The interest calculation can then be made in total, as before.

Example

Y lent D £200 for one year, E £300 for two years and F £250 for four years at 5 per cent per annum. If separate calculations are made:

The interest on D's loan is	£200 × $\frac{5}{100}$ =	£10
,, ,, ,, E's ,, ,,	£300 × 2 × $\frac{5}{100}$ =	£30
,, ,, ,, F's ,, ,,	£250 × 4 × $\frac{5}{100}$ =	£50
	Total	£90

If it is desired only to calculate the total amount of interest:

Products:	£200 × 1 =	200
	£300 × 2 =	600
	£250 × 4 =	1,000

Interest on £1,800 for one year = £1,800 × $\frac{5}{100}$ = £90.

When periods of less than one year or broken parts of a year are involved, the calculation is made in the same way, substituting days or months for years according to the circumstances of the case.

Example

To find the total interest on £300 for three months, £400 for five months, £700 for eight months and £600 for ten months, at 4 per cent per annum.

Products:	£300 ×	3 =	900
	£400 ×	5 =	2,000
	£700 ×	8 =	5,600
	£600 ×	10 =	6,000

Interest on £14,500 for *one month* at 4 per cent per annum = £14,500 × $\frac{1}{12}$ × $\frac{4}{100}$ = £48 6s. 8d.

Products can also be used for the calculation of discount (on bills) in total.

Example

X holds three bills, for £300 due in seventy days, for £400 due in eighty days and for £500 due in ninety days. If he discounts them at 4½ per cent per annum how much will he receive?

Products:	£300 × 70	=	21,000
	£400 × 80	=	32,000
	£500 × 90	=	45,000
	£1,200 Discount on		£98,000 for one day at 4½ per cent per annum

= £98,000 × $\frac{1}{365}$ × $\frac{4\frac{1}{2}}{100}$ = £12 1s. 8d.

X will, therefore, receive £1,200 less £12 1s. 8d. = £1,187 18s. 4d.

AVERAGE DUE DATE

Products also enter into the calculation of the average due date of a number of transactions. The usual reason for this calculation is the desire to substitute one payment for several that would otherwise have become due on various dates. The one payment is to equal the separate ones in total and is to be made on such a date that there will be no loss or gain of interest to either party.

Example

M has accepted the following bills in favour of N:

£200	due on	April	12	(including days of grace)
£300	,, ,,	May	10	,, ,, ,, ,,
£250	,, ,,	June	15	,, ,, ,, ,,
£400	,, ,,	July	6	,, ,, ,, ,,

It is desired to cancel these bills and to substitute for them a new bill for £1,150 to mature on the average due date.

Taking the date of the first bill (April 12) as starting point or zero date:

From	April 12 to May 10	=	28 days
	April 12 to June 15	=	64 days
	April 12 to July 6	=	85 days

The product of each bill and the number of days from April 12 to its maturity date is then found:

Product:	£200 × 0	=	0
	£300 × 28	=	8,400
	£250 × 64	=	16,000
	£400 × 85	=	34,000
	£1,150		58,400

On dividing the total of the products by the total of the amounts, the average date is found to be

$$\frac{58{,}400}{1{,}150} = 50.8 \text{ days after April 12.}$$

A fraction of a day cannot be considered where the due date of a bill is concerned; the new bill should, therefore, fall due fifty days after April 12, that is, on June 1.

It will be noticed that the calculation is not affected by the date on which the new bill is actually drawn. Any date can be chosen for zero date, but by making this the date of the first bill the number of days from it to each of the other dates is reduced to a minimum and the products are kept as small as possible. Further, the first product is itself nil and one multiplication is thus avoided.

COMPOUND INTEREST

When interest is to be charged on the balance of an account it is necessary to consider at what dates, if any, it is to be taken into the account, thus becoming part of a new balance on which the next calculation of interest is to be made.

The calculation of (simple) interest on £400 for three years at 5 per cent per annum, which was seen to be £400 × $\frac{5}{100}$ × 3 = £60, assumed that the interest was not to be taken into account until the end of the period of three years. Alternatively, if the £400 was a loan from A to B, it may have been intended that B should pay the interest to A at the end of each year. He would then have paid £20 a year for three years, making £60 in all.

If, now, £400 represents an amount owing by B to A and it is agreed that he shall be charged interest at 5 per cent per annum on the annual balance until such time as he can pay it, and in fact he paid nothing until the end of the third year, his total liability would be:

	£	s.	d.
Amount owing at beginning of first year	400	0	0
Interest for first year at 5 per cent per annum	20	0	0
Amount owing at beginning of second year	420	0	0
Interest for second year at 5 per cent per annum	21	0	0
Amount owing at beginning of third year	441	0	0
Interest for third year at 5 per cent per annum	22	1	0
Amount to be paid at end of third year (representing principal £400, interest £63 1s.)	£463	1	0

It will be observed that the difference between simple interest (£60) and compound interest (£63 1s.) is in this case only £3 1s. Had the transaction run on for a very large number of years, however, the difference would have become very substantial, since it is cumulative in its effect.

In the above example the interest was stated to be chargeable on the annual balance. This is sometimes called compound interest with "yearly rests," but it does not follow that compound interest is always so charged. Interest can be taken with "half-yearly rests" or at any other agreed intervals. A rate of interest of, say, 5 per cent per annum, with half-yearly rests, is really equivalent to compound interest at 2½ per cent per half-year, and represents a slightly higher charge than 5 per cent per annum with yearly rests.

Thus, the above example re-worked with half-yearly rests and set out in columnar form, would yield the following results:

Half-year	*Amount Outstanding at beginning of half-year*			*Interest for half-year at 2½ per cent*			*Amount Outstanding at end of half-year*		
	£	s.	d.	£	s.	d.	£	s.	d.
1	400	0	0	10	0	0	410	0	0
2	410	0	0	10	5	0	420	5	0
3	420	5	0	10	10	2	430	15	2
4	430	15	2	10	15	4	441	10	6
5	441	10	6	11	0	9	452	11	3
6	452	11	3	11	6	3	463	17	6

Here, again, the difference in the figures over a period of three years is comparatively small, but over a long period it would be substantial.

When it is desired to calculate, in advance, the result of a transaction involving compound interest for a number of years it is not necessary to make the calculation in detail, as in the above example. The result can be obtained:

(1) By a mathematical calculation involving the use of logarithms or a suitable calculating machine.

(2) By the use of interest tables.

The book-keeper is generally concerned with such calculations only in so far as they relate to sinking funds, either for the replacement of a wasting asset or the redemption of a long-term liability.

Example

For the purpose of redeeming a mortgage it is desired to calculate how much must be set aside annually on the assumption that it will be possible to invest in suitable securities showing a yield of 3 per cent per annum, the interest received being reinvested on the same terms, to produce the sum of £10,000 at the end of 30 years. The first investment is to be made at the end of the first year.

(1) *By mathematical calculation.*

If £100 per annum be invested on the above terms: the amount invested at the end of the first year is £100. The interest received at the end of the second year is £100 $\times \frac{3}{100}$. The first investment has, therefore, increased at the end of the second year to £100 + £100 $\times \frac{3}{100}$ = £100 $(1 + \frac{3}{100})$. With the interest received at the end of the third year this becomes £100 $(1 + \frac{3}{100})$ + £100 $(1 + \frac{3}{100}) \frac{3}{100}$ = £100 $(1 + \frac{3}{100})(1 + \frac{3}{100})$ = £100 $(1 + \frac{3}{100})^2$, and so on until the end of the 30th year, when it will have grown to £100 $(1 + \frac{3}{100})^{29}$.

Similarly, the £100 invested at the end of the second year will grow to £100 $(1 + \frac{3}{100})^{28}$, and so on, while the last £100 set aside at the end of the 30th year will not earn any interest at all, and will therefore amount to £100.

The total yield of all the £100 investments will, therefore, be:

$$£100\left((1 + \tfrac{3}{100})^{29} + (1 + \tfrac{3}{100})^{28} + (1 + \tfrac{3}{100}) + 1\right).$$

Whence, summing the geometrical progression:

$$= £100\left(\frac{(1 + \frac{3}{100})^{30} - 1}{(1 + \frac{3}{100}) \quad - 1}\right) = £100\,\frac{(1{\cdot}03^{30} - 1)}{{\cdot}03} = £4757{\cdot}5.$$

By simple proportion the amount required to produce £10,000 is:

$$£10{,}000 \times \frac{100}{4757{\cdot}5} = £210{\cdot}194$$

or, say, £210 4s. per annum.

Note. The calculation of $1{\cdot}03^{30}$ requires the use of logarithms, thus:

$$\begin{array}{rl} \text{log. } 1{\cdot}03 = & {\cdot}0128372 \\ & 30 \\ \hline & {\cdot}3851160 = \text{log. } 2{\cdot}42726. \end{array}$$

The use of compound interest tables is obviously to be preferred.

(2) *By using Compound Interest Tables.*

The 3 per cent table shows that £1 per annum invested at the end of each year for thirty years will amount to £47·5754. By simple proportion, the amount required to be invested to produce £10,000 is, therefore, $£\frac{10{,}000}{47{\cdot}5754}$ = £210·193, or, say, £210 4s.

An account current is a personal account recording commercial or financial transactions between two persons (who stand to each other in the relationship of debtor and creditor) during a given period and showing the balance due from the one to the other at the end of that period.

In this sense any account in a trader's Bought and Sold Ledgers is an account current and may correctly be so described. It is usual, however, to restrict the use of the term account current to accounts which, by agreement between the parties, are to carry interest upon the outstanding balances. The account then has to be arranged in such a way that the calculation of interest is facilitated and the interest itself, when calculated, has to be entered in the account and constitutes part of the final balance.

If the final balance so calculated is not to be settled forthwith, but is to go forward and constitute the opening balance of an account covering the next period, then the inclusion of the interest in this balance constitutes a form of compound interest. It follows that in such cases the parties must have agreed at what intervals the balance is to be struck, for it has been seen that a given rate of interest per annum with "yearly rests" (that is, balances) does not give the same result if it is applied with "half-yearly rests." Savita

Within the period covered by the account, or in cases where the balance is not to be carried forward but is to be settled forthwith, the interest charged is, of course, in the nature of simple interest. It follows, therefore, that in the detailed calculations the interest appropriate to each item will be a product of the amount of the item, the number of days or months for which interest on it is to be calculated and the rate of interest agreed upon. From this it will be seen that the use of a "products" method will generally reduce the arithmetical work considerably.

An account, in the ordinary sense, will usually (but not necessarily) contain items on both debit and credit sides, resulting in a net balance due by one party to the other. Interest, if chargeable, relates strictly to the balances outstanding from time to time, as each transaction, whether debit or credit, is taken into account. Where the account is so arranged that the new balance is shown every time an entry is made (as, for example, in the common form of bank statement, whether the account be in credit or overdrawn) interest can be calculated on those balances, either separately or in total by the use of products.

Example

X sold goods to A as follows: On April 15 £300, May 22 £200, June 16 £125, September 30 £110.

A made payments on account as follows: On June 1 £250, October 1 £250.

In view of the extended credit granted to A it was agreed that he should be charged interest at 4 per cent per annum on the balances outstanding from day to day, the first calculation to be made up to December 31, when an account current is to be rendered to him, showing the balance outstanding, including interest.

(1) *If separate calculations of interest are made.*

A IN ACCOUNT CURRENT WITH X

Date	Details	Dr.	Cr.	Balance (Dr.)	Days	Interest
						£ s. d.
April 15	To Goods	300 0 0		300 0 0	37	1 4 4
May 22	,,	200 0 0		500 0 0	10	11 0
June 1	By Cash		250 0 0	250 0 0	15	8 3
16	To Goods	125 0 0		375 0 0	106	4 7 1
Sept. 30	,,	110 0 0		485 0 0	1	1 1
Oct. 1	By Cash		250 0 0	235 0 0	91	2 6 10
Dec. 31	To Interest	8 18 7		243 18 7		
	Balance c/d		243 18 7		260	£8 18 7
		£743 18 7	£743 18 7			
Jan. 1	To Balance b/d	243 18 7		243 18 7		

(2) *If "products" are used.*

A IN ACCOUNT CURRENT WITH X

Date	Details	Dr.	~~Dr.~~ Cr	Days	Balance (Dr.)	Product
April 15	To Goods	300 0 0		37	300 0 0	11,100
May 22	,,	200 0 0		10	500 0 0	5,000
June 1	By Cash		250 0 0	15	250 0 0	3,750
16	To Goods	125 0 0		106	375 0 0	39,750
Sept. 30	,,	110 0 0		1	485 0 0	485
Oct. 1	By Cash		250 0 0	91	235 0 0	21,385
Dec. 31	To Interest at 4 per cent p.a. on £81,470 for 1 day	8 18 7		260		81,470
	By Balance c/d		243 18 7			
		£743 18 7	£743 18 7			
Jan. 1	To Balance b/d	243 18 7				

Method (1). The number of days entered in the column headed *Days* is the period elapsing between each change in the balance due from A. Thus, the first balance, £300, commences on April 15 and remains unaltered until May 22. When counting the number of days, the commencing date is ignored, since the first day's interest arises on the following day. Thus, excluding April 15, fifteen days remain in April, and these, added to the twenty-two days in May up to and including May 22, give a total of thirty-seven days for the first interest calculation, which is, therefore:

$$£300 \times \frac{4}{100} \times \frac{37}{365} = \frac{£444}{365} = £1{\cdot}216 = £1\ 4s.\ 4d.$$

The number of days and the resulting interest for each of the other balances involve similar calculations.

Although it is not essential that the Days column should be added up, by doing so a useful check is obtained. Thus, from April 15 to December 31 is 15 + 31 + 30 + 31 + 31 + 30 + 31 + 30 + 31 = 260 days. This, within limits, proves the accuracy of the detailed figures in the Days column (but it does not check the interest calculations beyond that).

Method (2). The number of days applicable to each balance was calculated as before and proved in total. Each balance was then multiplied by its number of days to give a product, interest on £300 for thirty-seven days being the same as interest on £11,100 for one day, and so on. Finally, interest was calculated for one day on the total of the products, namely:

$$£81{,}470 \times \frac{4}{100} \times \frac{1}{365} = £8{\cdot}929 = £8\ 18s.\ 7d.$$

Although interest really arises in respect of the various balances in an account, as shown in the foregoing example, it can in fact be calculated without striking any balances other than the final one.

Thus, in the example, had the only two transactions been the debits of £300 and £200 on April 15 and May 22 respectively, the same result would be obtained by taking interest on: (*a*) £300 for 37 days and £500 for 223 days, or (*b*) £300 for 260 days and £200 for 223 days; or, in other words, by taking it either on the balances or on the separate items, the number of days in the latter case being calculated from the date of the transaction up to the end of the year.

Similarly, had the only two transactions been the debit of £300 on April 15 and the credit of £250 on June 1, the same result would be obtained by taking interest on (*a*) £300 for 47 days *plus* £50 for 213 days, or (*b*) £300 for 260 days *less* £250 for 213 days.

In the account as it stands, therefore, interest can be calculated on (*a*) the four debit items and (*b*) the two credit items; the difference between the two amounts of interest thus obtained should be the same as before. Alternatively, two sets of products can be calculated and interest is then taken in one sum on the balance of products.

Example (continued)

(3) *Calculating interest on each transaction.*

A IN ACCOUNT CURRENT WITH X

Date	Details	Days	Interest	Amount	Date	Details	Days	Interest	Amount
April 15	To Goods	260	8 10 11	300 0 0	June 1	By Cash	213	5 16 8	250 0 0
May 12	,,	223	4 17 9	200 0 0	Oct. 1	,,	91	2 9 10	250 0 0
June 16	,,	198	2 14 3	125 0 0	Dec. 31	Interest to contra		8 18 7	
Sept. 30	,,	92	1 2 2	110 0 0		Balance c/d			243 18 7
Dec. 31	Interest, per contra			8 18 7					
			£17 5 1	£743 18 7				£17 5 1	£743 18 7
Jan. 1	To Balance b/d			243 18 7					

(4) *Calculating interest on a balance of products.*

A IN ACCOUNT CURRENT WITH X

Date	Details	Days	Product	Amount	Date	Details	Days	Product	Amount
April 15	To Goods	260	78,000	300 0 0	June 1	By Cash	213	53,250	250 0 0
May 22	,,	223	44,600	200 0 0	Oct. 1	,,	91	22,750	250 0 0
June 16	,,	198	24,750	125 0 0	Dec. 31	Balance of products		81,470	
Sept. 30	,,	92	10,120	110 0 0		Balance c/d			243 18 7
Dec. 31	Interest (at 4 per cent p.a. on £81,470 for one day)			8 18 7					
			157,470	£743 18 7				157,470	£743 18 7
Jan. 1	To Balance b/d			243 18 7					

VALUE DATE

In the examples so far considered each transaction carried interest from its own date. Circumstances may arise, however, in which a transaction is given a "value date," for the purpose of interest, which differs from its actual date. The commonest examples are found in the following circumstances:

(1) Where invoices for goods sold are "dated forward" for the purpose of fixing the date when payment is due. The normal terms of settlement between a wholesaler and retailer may provide for payment on the 5th of the month following that in which the goods are invoiced. A retailer who is unwilling to increase his commitments for the current month may then agree to accept further deliveries of goods from a wholesaler, provided the invoices are dated to the next month. This will give him an additional month's credit and enable him to effect further sales of the goods before having to pay for them.

The retailer should record the purchase of the goods on the date when he actually receives them; otherwise, if there are any such

transactions outstanding when he balances his books and prepares his annual accounts, his profits will be overstated if he has either sold the goods or included them in his stock valuation.

It is sometimes suggested that, where the goods have not been sold, the correct result can be obtained by excluding them from purchases and stock. This ignores the fact that the property in the goods passed when they were delivered to the retailer, and if the suggestion is followed the Balance Sheet will understate both the assets and liabilities of his business. Moreover, as it would still be necessary to make a careful scrutiny of the transactions to see whether any of the goods had in fact been sold, it is both simpler and sounder to enter them as purchases on the date of delivery.

To enable the supplier's account in the Bought Ledger to show the agreed date of payment, the two dates will be entered in the date column, for example, "April 15 as May 1."

(2) The acceptance of a bill of exchange presupposes an agreement to pay cash on the due date of the bill—not on the date when it was drawn or accepted. If the bill enters into an Account Current carrying interest, the number of days will, therefore, be counted from the due date of the bill and not from the date on which it was entered.

Example

P sold goods to Q as follows: On August 1 £95 10s.; September 8 £65 3s. 6d.; October 10 £123 1s. 9d.; November 2 £82 3s. 8d. In each case it was agreed that the invoices should be dated forward to the first of the following month. Q was unable to make any payment on September 1, so on that date P drew a bill of exchange, payable 3 months after date, for £200, which Q accepted. Q met this bill when it fell due but otherwise made no payment to P up to December 31. He agreed to pay interest at 5 per cent per annum on the overdue balances on his account, and P drew up the following Account Current to show the position at December 31. Interest calculations were made in months.

Q IN ACCOUNT CURRENT WITH P

Date	*Details*	*Months*	*Product*	*Amount*	*Date*	*Details*	*Months*	*Product*	*Amount*
Aug. 1 as Sept. 1	To Goods	4	382	95 10 0	Sept. 1	By Bill Receivable, due Dec. 4	1	200	200 0 0
Sept. 8 as Oct. 1	,,	3	195	65 3 6	Dec. 31	Balance c/f			168 17 8
Oct. 10 as Nov. 1	,,	2	246	123 1 9		Balance of products to contra		705	
Nov. 2 as Dec. 1	,,	1	82	82 3 8					
Dec. 31	Interest on £705 for one month			2 18 9					
			905	£368 17 8				905	£368 17 8

The introduction into an Account Current of value dates which are in advance of the dates on which some of the entries are made may sometimes result in the balancing date being earlier than one or more of the value dates. The number of days then has to be counted backwards from the value date to the balancing date; it is thus a negative quantity and must be treated as such in the calculation of interest, whether by products or otherwise. This can be achieved either by the use of red ink to indicate negative figures or by carrying the appropriate calculations to the other side of the account, which has, of course, the same effect.

Example

The following is the Sales Ledger Account of R in the books of S:

R

Jan. 1	To Balance b/f	123 2 8	Feb. 1	By Cash	100 0 0
Feb. 2 as Mar. 5	Goods	69 3 11	May 3	Bill Receivable due Aug. 6	200 0 0
Mar. 1	”	48 2 6	June 30	Balance c/d	120 19 6
May 6	”	180 10 5			
		£420 19 6			£420 19 6
July 1	To Balance b/d	120 19 6			

The account re-presented in the form of an Account Current, with interest calculated at 4 per cent per annum, will appear in one of the following two ways:

(1) *Making separate calculations of interest.*

R IN ACCOUNT CURRENT WITH S

Date	*Details*	*Days*	*Interest*	*Amount*	*Date*	*Details*	*Days*	*Interest*	*Amount*
Jan. 1	To Balance b/f	181	2 8 10	123 2 8	Feb. 1	By Cash	149	1 12 8	100 0 0
Feb. 2 as Mar. 5	Goods	117	17 9	69 3 11	May 3	Bill Receivable, due Aug. 6	*37*	*16 2*	200 0 0
Mar. 1	”	121	12 9	48 2 6	June 30	Interest, to contra		4 4 7	
May 6	”	55	1 1 9	180 10 5		Balance c/d			125 4 1
June 30	Interest, per contra			4 4 7					
			£5 1 1	£425 4 1				£5 1 1	£425 4 1
July 1	To Balance b/d			125 4 1					

Note. The figures in italic are written in *red ink* and the *16s. 2d.* is treated as a *deduction* in the credit Interest column.

(2) *Using products.*

R IN ACCOUNT CURRENT WITH S

Date	Details	Days	Product	Amount	Date	Details	Days	Product	Amount
Jan. 1	To Balance b/f	181	22,263	123 2 8	Feb. 1	By Cash	149	14,900	100 0 0
Feb. 2 as Mar. 6	Goods	117	8,073	69 3 11	May 3	Bill Receivable, due Aug. 6			200 0 0
Mar. 1	,,	121	5,808	48 2 6	June 30	Balance c/d			125 4 1
May 6	,,	55	9,955	180 10 5		(Balance of products to contra)		38,599	
June 30	(Bill Receivable, due Aug. 6 per contra £200)	37	7,400						
	Interest on £38,559 for one day at 4 per cent p.a.			4 4 7					
			53,499	£425 4 1				53,499	£425 4 1
July 1	To Balance b/d			125 4 1					

Note. Alternatively, the debits for days 37 and product 7,400 could have been entered in red ink on the other side against the credit of £200 for the bill to which they relate.

The following points should be noted:

(1) The first entry in the account is the balance brought forward on January 1. The value date of this item is really December 31 in the preceding year—the date up to which the last calculation of interest was (presumably) made. The number of days, 181, therefore, includes both the opening date of the account (January 1) and the closing date (June 30) and in this respect may be regarded as an exception to the general rule.

(2) When calculating products, the amounts are usually taken to the nearest £1. This does not involve any substantial loss of accuracy, as is seen by the fact that the two methods give the same result.

(3) Although the bill due on August 6 gives rise to negative or "red ink" interest, the bill itself is brought into account on May 3.

ENTRIES IN BOOKS OF ACCOUNT

It should be emphasized that the Accounts Current illustrated in the preceding examples will not normally appear in that form in the books of either party. They are documents prepared outside the books for the dual purpose of calculating interest and showing how the final balance which the creditor is claiming from his debtor is made up.

The ledger accounts which record the transactions giving rise to the Account Current will show the balance due before interest has been

calculated. A journal entry will then be made to bring the interest into account and a revised balance will be carried down. This will apply whichever method is used for calculating the interest.

Example

R's account in the Sales Ledger of S is shown on page 388. When the interest has been calculated and found to be £4 4s. 7d. a journal entry will be made:

June 30	R Dr. To Interest Receivable being Interest as per Account Current.	4 4 7	
			4 4 7

On posting this to R's account the latter will then show the same balance as the Account Sales:

R

			£ s. d.				£ s. d.
June 30	To Balance	b/d	120 19 6	June 30	By Balance	c/d	125 4 1
	Interest	J	4 4 7				
			£125 4 1				£125 4 1
July 1	To Balance	b/d	125 4 1				

JOINT VENTURES

Transactions which are entered into jointly by two or more parties for their mutual benefit and fall short of being partnerships (generally because they do not constitute a business, although they are carried on "in common" and with "a view of profit") are generally known as joint ventures. It is possible that some joint ventures are in law partnerships, since the Partnership Act recognizes the possibility of a partnership being entered into for the "duration of a venture," but it may be considered unnecessary to open a special set of books in such cases. The essential records are then found in the books kept by each party in respect of his own business.

The participation of each party in the joint venture can be regarded as in the nature of an investment. The simplest system of book-keeping under which he keeps one account only to record all his transactions which concern the venture is, therefore, the best, for this account then shows, at any time, his net stake or investment in the venture. This account will not, in itself, show the final result of the venture; for that purpose the transactions of all the parties will have to be summarized. This last account does not normally appear in any set of books and is, therefore, of a memorandum nature; it serves the purpose of showing the profit or loss on the venture as a whole and how that profit or loss is to be shared between the parties. Each party or "venturer" then takes his own share of profit into his own books.

Profits or losses will be shared in accordance with the agreement. If the agreement is silent on this point (which would be most unusual), Section 24 of the Partnership Act must be applied and the profit or loss shared equally, without any adjustment for the (possibly) varying amounts of capital contributed or services rendered by each party.

A simple example will serve to illustrate the method.

Example

A and B, who are both general merchants, agree to enter into a joint venture. A sent to B goods valued at £600 out of his (A's) stock and B added further goods to the value of £400. A paid carriage and other expenses amounting to £50. B sold all the goods for £1,500 and incurred selling expenses of £100. Profits or losses were shared equally. B drew up an account to show the result of the joint venture and sent A a cheque for the amount due to him.

In A's Books

An account will be opened called Joint Venture with B, and pending the ascertainment of the profit this shows A's investment in the venture:

	£		
To Goods	600		
Cash	50		

From A's point of view the transaction is similar in some respects to a consignment. The double entry for the debit of £600 should, therefore, be completed in an account called Goods Consigned on Joint Account. Alternatively, if the £600 is the cost of the goods, the credit can be taken to Purchases Account. A should *not* treat the transaction as an ordinary sale.

The double entry for the £50 expenses will, of course, be found in the Cash Book.

The closing of the account in A's books will be considered after the profit has been ascertained. In the meanwhile A will have sent B a copy of the account or will have advised him as to the expenses incurred on Joint Account.

In B's Books

An account called Joint Venture with A will have been opened and records, in a similar way, B's stake in the venture. This account shows a credit balance, however, because B has received the proceeds of sale:

	£		£
To Goods	400	By Cash (or Sales Ledger)	1,500
Cash	100		

B now combines the figures in his own account with those notified to him by A and produces the following (memorandum) Joint Venture Account:

A AND B JOINT VENTURE ACCOUNT

	£	£		£
To Goods provided by A	600		By Proceeds of Sale	1,500
Goods provided by B	400			
		1,000		
Expenses paid by A	50			
Expenses paid by B	100			
		150		
Net Profit, divided equally A	175			
B	175			
		350		
		£1,500		£1,500

The cheque sent to A will be for £825, being (1) reimbursement of his expenditure, £650; (2) his share of profit, £175.

The completed accounts in the books of each party will then be as follows:

In A's Books

JOINT VENTURE WITH B

	£		£
To Goods	600	By Cash from B	825
Cash	50		
Profit and Loss Account	175		
	£825		£825

In B's Books

JOINT VENTURE WITH A

	£		£
To Goods	400	By Cash	1,500
Cash	100		
Profit and Loss Account	175		
Cash to A	825		
	£1,500		£1,500

The same method would apply if there were three or more parties to the venture.

Joint ventures are normally concerned with the sale of goods, but similar principles can be applied to a joint investment in stocks and shares or land. In such cases, however, it cannot necessarily be supposed that the parties are keeping books of account; if they are, the venture might well be regarded as a private transaction and excluded from their business books. It would, therefore, be as well to keep a ledger for the

venture as such. This will be similar in principle to an ordinary set of books and will contain a Capital Account for each participant, but instead of separate nominal accounts being opened for purchases, sales and so on, all entries affecting profit or loss will normally go straight into the Joint Venture Account.

If this method were applied in the example already considered, the books of the joint venture would comprise:

CAPITAL ACCOUNTS

	A £	B £		A £	B £
To Proceeds of Sale		1,500	By Goods	600	400
Cash received from B	825		Expenses	50	100
			Share of Profit	175	175
			Cash paid to A		825
	£825	£1,500		£825	£1,500

The Joint Venture Account will appear as before, but in this case it constitutes part of the double-entry system of book-keeping and is, therefore, not a memorandum account.

As the goods came out of the stocks of A and B and the expenses were paid out of their business banking accounts, they will still have to open the Joint Venture Accounts in their own books. No useful purpose is really served, therefore, by opening separate books for the venture in the particular circumstances of this example.

Where the goods are bought on joint account, and not supplied from the stock of one or other of the parties, it may be decided to open a joint banking account for the purpose of financing the venture. This takes the transactions outside the ambit of the venturers' own books of account and a separate set of books should always be opened in such cases. A small ledger of the exercise-book type would normally suffice. The best method of book-keeping to apply in any particular case is the simplest one that is possible in the circumstances.

Example

Penny and Black, who were both interested in philately as a hobby, agreed to join in a venture involving the purchase and sale of foreign stamps, sharing profits in the ratio of 2 : 1 respectively. They opened a joint banking account to which Penny contributed £1,000 and Black £500. Stamps were purchased at a cost of £1,200 and were consigned to a dealer in the United States, who sold some of them for $7,500 net, returning the unsold stamps and a draft for the proceeds of sale, which realized £1,800 when paid into the bank account. Expenses, all defrayed from the joint account, amounted to £60 and the unsold stamps were taken over by Penny at an agreed valuation of £240.

The accounts necessary to record these transactions are as follows:

CAPITAL ACCOUNTS

	P	B		P	B
	£	£		£	
To Stamps taken over	240		By Cash	1,000	500
Cash	1,280	760	Share of Profit	520	260
	£1,520	£760		£1,520	£760

JOINT BANK ACCOUNT

	£		£
To Capital A/cs		By Stamps purchased	1,200
Penny	1,000	Expenses	60
Black	500	Penny	1,280
Proceeds of Sale	1,800	Black	760
	£3,300		£3,300

JOINT VENTURE ACCOUNT

		£		£
To Cost of Stamps		1,200	By Proceeds of Sale	1,800
Expenses		60	Penny—unsold stamps at agreed valuation	240
Balance, profit:				
Penny	£520			
Black	£260			
		780		
		£2,040		£2,040

As in a partnership, the parties to a joint venture may agree that interest is to be taken into account before profits are divided. But whereas in a partnership the interest is normally calculated on a fixed balance of capital subscribed by each partner, in a joint venture it will apply to each transaction according to its date. The resulting calculation will, therefore, take the form of an Account Current.

Example

X and Y agreed to enter into a joint venture, profits being shared equally after allowing for interest at 6 per cent per annum on their net contributions (calculations to be made in months). X purchased goods at a cost of £3,000, paying £1,000 in cash on February 1 and accepting a bill due on April 1 for the balance. On the same day he received £400 from Y as his contribution towards the cost.

The goods were sold by X on March 1 for £4,000, and on the same day he paid expenses £300. Of the proceeds of sale £2,000 was received in cash on March 1 and the balance was represented by a bill receivable in favour of X, due on June 1. X met his bill payable on April 1 and one month later closed the venture by remitting the appropriate amount to Y.

Entries in X's Books

JOINT VENTURE WITH Y

		Interest	Amount			Interest	Amount
		£	£			£	£
Feb. 1	To Cash	15	1,000	Feb. 1	By Cash from Y	6	400
	Bill Payable, due April 1	10	2,000	Mar. 1	Cash	20	2,000
Mar. 1	Cash (Expen.)	3	300		Bill Receivable, due June 1	(−10)	2,000
May 1	Interest, p. contra		12	May 1	Interest, to contra	12	
	Profit and Loss A/c		341				
	Cash to Y		747				
		£28	£4,400			£28	£4,400

Entries in Y's Books

JOINT VENTURE WITH X

Feb. 1	To Cash to X	6	400	May 1	By Interest, to contra	6	
May 1	Interest, p. contra		6		Cash from X		747
	Profit and Loss A/c		341				
		£6	£747			£6	£747

(Memorandum)

JOINT VENTURE ACCOUNT

Feb. 1	To Goods	15	1,000	Mar. 1	By Proceeds	20	2,000
	,,	10	2,000		,,	(−10)	2,000
Mar. 1	Expenses	3	300	May 1	Interest, to contra	18	
May 1	Interest, p. contra		18				
	Profit: X £341 Y £341		682				
		£28	£4,000			£28	£4,000

QUESTIONS AND EXERCISES

(Key to answers on page 571)

(1) AW & Co. consigned 50 cases of goods to their agents, ET & Co. of Calcutta, together with a pro-forma invoice for £1,000. The consignors also paid freight of £1 10s. per case and insurance on the whole consignment of £25 by cheque. On receipt of the goods the consignees remitted a sight draft for £600. In due course they sent an Account Sales to the consignors showing that the goods had realized £29 10s. per case, that landing and storage charges amounted to £12, and insurance £3 had been paid out of these proceeds. Together with this account was remitted a draft for the balance due to the consignors, less the agents' commission of 4 per cent of the gross sales.

Show how these transactions would appear in the books of AW & Co.

(*R.S.A. Stage II*).

(2) W. Ireland of Belfast consigned goods to his agent, A. Scott of London, and forwarded a pro-forma invoice for £600. The agent remitted a cheque for £300 on receipt of the goods and the arrangement was that he should receive 5 per cent commission on the gross sales. A. Scott paid various charges on the consignment amounting to £12 8s. 6d. He sold the goods for £715 10s., received a cheque for that amount from the purchaser, and remitted the amount due to the consignor.

Show how these transactions would appear (*a*) in the books of the consignor and (*b*) in the books of the agent. (*R.S.A. Stage II*).

(3) On January 15, Export, Limited, of London, consigned to Buy British, Limited, of Melbourne, fifty cases of hardware, invoicing them at cost, namely, £30 per case. Export, Limited, paid expenses by cheque in connexion with the matter as follows: Insurance £15 3s. 6d., Freight £54 1s. 10d., Sundry Charges £6 3s. 9d.

By arrangement, Export, Limited, drew on Buy British, Limited, at 90 days for £1,200 and discounted the bill at the bank (discount £15).

Buy British, Limited, paid expenses in Australia as follows: Storage £27 1s. 9d., Insurance £3 6s. 1d.

On March 1, Buy British, Limited, sold thirty cases at £40 each cash, and on March 5 the balance at £45 each cash. Their commission is 2 per cent on gross sales, plus $1\frac{1}{2}$ per cent *del credere*. On April 8, an Account Sales is received in London with a draft on the Australia Bank, Limited, in settlement.

Show how these matters would appear in the Cash Book and Ledger of Export, Limited. Neither the Account Sales nor any other books need be shown.

(*Inst. of Bankers, Part I*).

(4) The X Company, Limited, consigned 100 tons of goods to its agent in Canada at £30 per ton, and paid insurance and freight amounting to £230 on October 15. On December 12 following, the company received an Account Sales showing the sale of 50 tons at £40 per ton and 25 tons at £42 per ton, less commission at 5 per cent on gross sales and less £90 expenses incurred in connexion with the consignment. The agent enclosed a draft in payment of the net proceeds. The X Company balanced its accounts on December 31. You are required to make the necessary entries in the books of the X Company, Limited, to record the above transactions and to balance the accounts as on December 31.

(*Chartered Accountants, Inter.*).

(5) Mr. Ewe Whiting owed his cousin, Mr. Wolf Whiting, the sum of £9,000 and, being unable to pay immediately, accepted four bills of exchange as follows:

£1,500 due date April 12		
2,500 ,, ,, May 15	Total £12,000	
3,500 ,, ,, July 22		
4,500 ,, ,, Sept. 8		

Shortly before April 12, Mr. Ewe Whiting learned that he had been left a substantial legacy and in these circumstances he agreed with Mr. Wolf Whiting to take up all the bills at the average date. You are required to find the average date. (*Chartered Accountants, Final*).

(6) A and Z have mutual dealings and it is arranged that interest shall be allowed between them at one-half per cent per mensem on the balances outstanding from time to time. You are required to draw up the account of Z in the ledger of A so as to display the following transactions and their results in the most advantageous manner:

			£
Jan.	1	Balance due by A to Z	1,000
,,	31	A sold to Z goods	500
,,	31	Z paid to A cash	250
Feb.	29	A purchased from Z goods	300
March	31	A received from Z cash	100
April	30	Z sold to A goods	750
June	30	A paid to Z cash	600
Aug.	31	Z purchased from A goods	500
Sept.	30	A returned to Z goods not up to sample	100
Oct.	31	Z paid to M at A's request, cash	600
Dec.	31	Z received from A, cash	150

(mensem = calendar month) (*Inst. of Bankers, Part I*).

(7) On March 31 George Shooter was indebted to Alfred Gunn to the extent of £550 for goods supplied. Further goods were purchased by him as follows: May 15 £870, June 22 £147, and July 18 £430. Certain of the goods proved to be faulty and were returned, credit being given for £58 on May 29.

Alfred Gunn drew on George Shooter for £550 on April 15 at three months after date and on June 26 drew a further bill at four months after date for the balance of the account. The parties subsequently agreed that interest at the rate of 5 per cent per annum should be taken into account as from March 31.

You are required to show the Account Current for the half-year to September 30, as it would be rendered by Alfred Gunn. The products method may be used, and interest calculated to the nearest £. (*Chartered Accountants, Inter.*).

(8) B is a motor dealer and salesman in a provincial town and receives from X, Ltd., twelve cars to be sold on the following terms:

(*a*) X, Ltd., is to receive for each car sold £300.

(*b*) Each party is to charge against the venture any expenses specifically incurred on this account.

(*c*) B is to receive £250 as remuneration for salesmanship, etc., and the balance of profit, after meeting all expenses, is to be shared equally between X, Ltd., and B.

The following further information is supplied to you:

(*a*) B sold eleven of the cars for cash at £450 each and one was returned to X, Ltd.

(*b*) X, Ltd., paid charges: Carriage and Packing £35, Insurance £15, Mechanic's Wages £8.

(*c*) B incurred the following expenses: £20 for petrol for demonstration, £40 for wages and £28 for repairs. In addition, he was allowed by agreement to charge £100 against the venture for use of garage and showroom.

Prepare a statement showing the profit or loss on the transactions, and give the entries in connexion therewith which should appear in the books of B.

(*C.I.S. Inter.*).

(9) Joseph Schwartz of Switzerland and Henry White of London entered into a transaction in connexion with a consignment of cameras. Schwartz bought the cameras in Switzerland for 15,109·50 francs (Swiss) and paid carriage and sundry expenses amounting to 572·25 francs. White paid customs duty amounting to £239 15s. and sundry expenses amounting to £19 5s. He sold the cameras for £1,325 and sent Schwartz a draft for 18,000 francs which cost £863 5s. 6d.

White was to receive a commission of 5 per cent of the gross proceeds, the balance of profit being divided equally. Draw up the Joint Venture Account as it would appear in the books of each party, taking the Swiss rate of exchange at 21 francs to the £. (*L.C. of C. Higher*).

(10) Thomas and Yardley, of London, and Rogers, of New York, entered into an agreement for the sale of a collection of pictures, the property of Yardley. Interest was to be taken into account as between the parties, at 5 per cent per annum, and Yardley was to be credited with £30,000 as representing the cost of the collection as on January 5, the date of the agreement. The profit was to be shared equally between the three parties. The following transactions took place:

Jan. 8 Thomas packed the collection and had it transported to his show-rooms, paying £73 the cost of packing and transport.
" 25 Thomas sold one picture for £2,500 (cash).
Feb. 25 Thomas gave Yardley a cheque for £10,000 and two bills of exchange for £10,000 each, due respectively three and six months after date.
March 2 Thomas sold further pictures for £6,050 (cash).
21 Thomas, by agreement, bought two pictures for his own stock at a valuation of £4,400.
" 23 The remainder of the collection was shipped to Rogers in New York, Thomas paying freight, etc., amounting to £860.
May 26 Rogers received delivery and paid charges amounting to $428.
" 27 Rogers sent Thomas a bill of exchange for £25,000, due three months after date.
" 28 Rogers sold certain of the pictures for $89,000.
June 4 Thomas discounted Rogers's bill for £24,621 6s. 6d. (the cost of this to be a charge against him personally).
" 6 Rogers sold the balance of the collection for $32,500.

It was agreed that Thomas and Rogers should each receive £200 for travelling and incidental expenses and the American exchange should be taken as $4.00 to the £.

On June 30 the three parties met in London and cheques were drawn in final settlement. Set out the entries recording these transactions in Thomas's Cash Book and ledger.

Note. Interest calculations to be made in months to the nearest month.
(*Chartered Accountants, Inter.*).

(11) Swift, a motor-car dealer, and Shoman, the owner of an exhibition hall, entered into a joint venture for the sale of used cars. It was agreed that an exhibition and sale of cars, for a period of one month, should be held in Shoman's hall and that profits or losses should be shared equally. The charge for the use of the hall, to include lighting and heating, was agreed at £400. Swift sent, from his own stock, cars costing £3,000, together with a further supply costing £2,000, which he obtained on sale or return from Barter. Swift supplied salesmen, whose salaries amounted to £75.

Shoman paid Attendants' Wages £45, Insurance £35, and Sundry Disbursements £60.

A joint bank account was opened, out of which the following payments were made: Drivers' and Mechanics' Wages £48, Salaries of additional Salesmen £80, Salesmen's Commission £285, Advertising £250.

Cars realizing £5,200 were sold for cash, which was paid into the joint bank account, and sales on credit amounted to £500. Of this amount £50 had been received by way of deposits and paid into the joint account. The balance outstanding was taken over by Swift for collection and subsequently received by him.

Swift took cars, costing £700, back into stock. Cars, costing £500, were returned by him to Barter, with a cheque for the balance due. One of the cars supplied by Swift, costing £100, was presented as a prize to the visitor most nearly guessing the number of those visiting the exhibition.

The joint bank account was closed by each party withdrawing the amount to which he was entitled. Prepare an account showing the result of the venture and show how the items relating thereto would appear in the bank and ledger accounts of Swift and Shoman respectively. (*Chartered Accountants, Final*).

(12) On March 1, A, having a balance at his bankers of £2,500, buys from B, Ltd., 100 milling machines at £50 each. On that date he pays B, Ltd., £2,000 and gives them a bill at six months for the balance, together with interest at 6 per cent per annum.

The machines are sent to C for re-conditioning at a cost of £840. When they are ready for sale, A instructs C to forward twenty-five of the machines to A's warehouse and twenty-five to D. The selling price is fixed at £75 per machine and sales are made as under:

	Total	*Cash*	*Credit*
	£	£	£
A	1,725	1,200	525
C	3,450	1,350	2,100
D	1,650	1,500	150

From sales made by him in cash, C retains the amount of his charges and also his expenses £75, and at once remits the balance to A. D likewise remits his cash sales to A, who, on May 1, rebates the bill at 5 per cent per annum interest for the unexpired term.

On May 20, C remits £1,750 to A on account of credit sales and advises a bad debt of £10. Credit sales made by A and D are collected in full, the amounts received being retained by them. Expenses are incurred by A £35 and by D £26 10s. Unsold machines held by each of the parties are taken over by them at £40 each.

Profits and losses are shared by A, C and D in the proportions 4 : 3 : 3 respectively. A made the final settlement on May 31.

You are required (*a*) to prepare an account of the venture, allowing three months' interest at 6 per cent per annum to A in respect of his cash advance of £2,000; (*b*) to record the transactions in the books of A, C and D.

(*Chartered Accountants, Inter.*).

(13) Jones, of London, traded in close association with Smith, of Glasgow. On January 1, 1938, Jones owed £120 to Smith and the following transactions took place during the same year:

1938

Jan. 31 Jones invoiced goods to Smith value £1,000.
Jones drew a bill at three months for £900 on Smith.
Jones received a cheque from Smith for £100.

March 28 Smith remitted £200 to Jones.

April 30 Smith invoiced goods to Jones value £150.

May 30 Jones supplied 1,500 articles, to oblige Smith, to one of the latter's customers in London. Smith agreed to credit Jones with £1 per article in respect of these goods. The customer paid his cheque for these to Jones on June 2 (25s. per article less 5 per cent cash discount) and Jones paid the customer's cheque into his own account.

July 31 Jones, having been credited in New York with \$500 in payment of a debt owing to him, arranged for this to be paid to Smith's agent in Chicago (assume £1 = \$5).

Aug. 31 Smith shipped goods to Brazil on Jones's instructions and invoiced them to Jones at an agreed amount, namely, £1,700. On the same day he drew a bill at three months on Jones for the full amount of the invoice.

Nov. 30 Smith received from Jones a cheque for £165.

You are required: (*a*) to prepare an Account Current, as rendered by Jones to Smith (a copy of the account in Jones's books) up to December 31, showing interest calculated at 5 per cent per annum (calculations in months; ignore shillings and pence); and (*b*) to show the balance on this account, including interest up to December 31, 1938. (*Chartered Accountants, Inter.*).

CHAPTER XVII

DEPARTMENTAL AND BRANCH ACCOUNTS

BUSINESSES may be divided into departments in the physical sense, the accounting sense or both. For example, a retail shopkeeper might sell fish and greengrocery from one shop. If separate records of sales and purchases of the two distinct commodities are not kept there is no division into departments. By using separate tills or installing a special cash register, or by carrying on the businesses from two distinct, but adjacent, shops the proprietor might be able to record the takings of each department separately. If the other essential figures, such as purchases and stocks, were also separated it would then be possible to prepare departmental accounts.

The ability to preserve separate records of the day-to-day transactions is an essential condition of departmental accounts; division of the business into departments in the physical sense may be of assistance in separating the records but it is not otherwise essential. Two or more departments may thus exist side by side in the same building or even in the same room.

Since a department is, by its nature, only one part of a whole, there will usually be some expenses which do not relate specifically to any one department. These are the overhead expenses or establishment charges of the business. Departmentalization may, in such cases, stop short at the Trading Account, the separate departmental gross profits being carried down to a combined Profit and Loss Account in which the overhead expenses are charged. Alternatively, the overhead expenses can be allocated to each department on some equitable basis and it will then be possible to ascertain the net profit or loss of each department.

The proper allocation of overheads in such circumstances is a matter of costing (see Chapter XX), but for the purpose of completing certain departmental accounts in this chapter any such allocation will be made in accordance with the data given, without going into the reasons therefor.

In general, the purpose of keeping departmental records is to enable separate Trading and Profit and Loss Accounts to be prepared for each department of a business which is capable of being so divided. The Balance Sheet, on the other hand, shows the financial position of the business as a whole on a given date and is not, as a rule, affected by departmentalization.

There is no limit to the extent to which departmental accounts can be developed. Thus, the fish department of the retail greengrocery and fish business might be further divided into wet, dry and fried departments, and if separate shops were used for each this would present little practical difficulty. If the three departments were carried on in one shop, however, the burden of segregating the records would probably be such that the practical disadvantages would outweigh the theoretical advantages.

Since some elaboration of the book-keeping records is always necessary if separate accounts are to be prepared, it may be advisable to consider whether any useful purpose is served by this additional labour. The advantages to be expected in any particular case will naturally depend to some extent upon the nature of the business and the degree of personal attention which can be given to it.

ADVANTAGES OF DEPARTMENTAL ACCOUNTS

Thus, if the proprietor of the combined greengrocery and fish business did his own buying and personally fixed the selling prices he would not really need departmental accounts to tell him the relative profitability of the two types of business. In larger concerns, such as a departmental store, or where ownership is not coincident with management and day-to-day experience of the business, the advantages are more apparent. They may be summarized as follows:

(1) The proprietors are made aware of the relative degrees of profitability of the various departments.

(2) The business can, therefore, be expanded in the directions which appear to offer greatest scope for profit. Alternatively, unprofitable departments can be discontinued.

(3) Payment by results is possible, departmental managers and assistants being given a commission on the profits of their departments. (This is more satisfactory than a commission on turnover, which merely encourages the building up of a large volume of sales without regard for their profitability or for the expenses incurred.)

(4) Inefficiencies or leakages may be detected in an account for one department, whereas if the same figures were merged in one set of accounts for the business as a whole, they would not invite attention.

(5) In times of poor trade, selling prices can be fixed at the lowest level of profitability for each department in order to keep the business in existence and to recover (perhaps only in part) the fixed overhead expenses, such as rent and rates, which go on at the same level whether goods are being sold or not.

TYPES OF DEPARTMENTAL ACCOUNTS

Departmental accounts are usually concerned with trading activities, the different departments being engaged in the sale of different "lines" or commodities. The first essential step in such cases is the segregation or analysis of the prime entries; this is considered in greater detail hereafter. Other examples of departmentalization are found in the following circumstances:

(1) Where the product passes through successive stages before it is sold (that is, where it is not bought and sold in the same condition). Any concern which manufactures its own product affords an example of this, for making and selling goods are two distinct operations or "departments"—represented, in the physical sense, by the factory and the warehouse respectively.

In such a case the presentation of separate Manufacturing and Trading Accounts, of which a simple example has already been

given on page 124, can be regarded as a development of departmental accounting.

(2) A firm which manufactures a variety of products might regard each product or convenient group of products as a different department and the factory might actually be divided into distinct departments (for example, foundry and machine shop). The calculation of the cost of production of each item in such cases is too complicated and detailed a matter to be approached on the usual lines of departmental accounts; it is, in fact, a matter of Cost Accounting and is considered as such in Chapter XX.

(3) Some concerns or organizations do not trade in the ordinary sense of making or selling goods, but render services, financial or otherwise. Insurance companies normally carry on several distinct types of insurance (Fire, Accident, Marine, Life, and so on), each of which constitutes a department of the business. In addition, such a business is usually transacted from several different branches as well as from a head office. It must be noted that in such cases the division into departments reflects the different *types of business*—not the different localities in which the business is obtained.

A detailed consideration of the book-keeping necessary to maintain the essential records and the accounting principles involved in the calculation of the profit or loss of each department would be beyond the scope of this book but the following accounts of a large insurance company illustrate the application of departmental accounts.

The Modern Assurance Company Limited

Revenue Accounts for the Year ending December 31

No. 1—Fire Account

		£			£
Fund at the beginning of the year:			Claims paid and outstanding		780,995
Reserve for unexpired risks		973,849	Commission		407,762
Premiums, *less* Re-insurances		1,936,110	Expenses of Management	£ 478,900	
Interest, Dividends and Rents	£ 59,416		Contributions to Fire Brigades	7,219	
Less Income Tax	13,680		Foreign Taxes	62,956	
		45,736			549,075
			Transferred to Profit and Loss Account:		
			Profit for the year	204,072	
			Interest	45,736	
					249,808
			Fund at the end of the year:		
			Reserve for unexpired risks, being 50 per cent of Premiums		968,055
		£2,955,695			£2,955,695

No. 2—Accident Account

		£			£
Fund at the beginning of the year:			Payments, including medical and legal expenses in connexion therewith		788,584
Reserve for unexpired risks		799,578	Commission		275,635
Estimated liability for outstanding claims		446,117	Expenses of Management		417,603
		1,245,695	Transferred to Profit and Loss Account:	£	
Premiums, *less* Re-insurances		1,671,522	Profit for the year	134,999	
Interest, Dividends and Rents	£ 50,744		Interest	38,997	173,996
Less Income Tax	11,747	38,997	Fund at the end of the year:		
			Reserve for unexpired risks, being 50 per cent of Premiums	835,761	
			Estimated liability in respect of outstanding claims	464,635	1,300,396
		£2,956,214			£2,956,214

BOOKS OF PRIME ENTRY

Departmentalization of the Day Books has already been illustrated in Chapter IV. Whether separate Day Books are used for each department, or one analysed book is used for the business as a whole, it is emphasized that there is only one account in the Personal Ledger for each supplier or customer. In other words, there is only one complete set of books, kept according to double-entry principles and from which a Trial Balance can be extracted periodically. If the departments are so self-contained as to keep their own books, they are regarded as *branches* and a different system of book-keeping will be appropriate.

Where the departments are dealing in commodities of a markedly different character it is perhaps unlikely that goods will be transferred from one department to another. If this does occur, however, the transfer should, if possible, be effected at the original cost of the goods to the department which first acquired them; any departure from this rule may lead to an overvaluation of the closing stock by taking credit for an inter-departmental "profit" which, from the point of view of the business as a whole, has not yet been realized.

Such transfers cannot very well be recorded in the Day Books as no posting to a personal account is involved. The journal proper should, therefore, be brought into use unless the transactions are of such frequency as to justify the installation of a Departmental Transfer Journal, of which the following is a specimen:

DEPARTMENTAL TRANSFER JOURNAL

Date	Particulars	Dept. A In	Dept. A Out	Dept. B In	Dept. B Out	Dept. C In	Dept. C Out
Jan.	Transfers						
	from A to B		106 13 2	106 13 2			
	„ A to C		324 16 2			324 16 2	
	„ B to A	291 10 11			291 10 11		
	„ B to C				10 2 6	10 2 6	
	„ C to A	410 15 9					410 15 9
	„ C to B			511 8 1			511 8 1
		702 6 8	431 9 4	618 1 3	301 13 5	334 18 8	922 3 10
		431 9 4		301 13 5			334 18 8
		£270 17 4		£316 7 10			£587 5 2

In the above example, the fact that Dept. A has transferred to Dept. B goods to the value (cost) of £106 13s. 2d. presupposes that these goods were originally purchased by Dept. A and have been recorded in the books as Dept. A Purchases. Where there is one central buying department which makes all purchases, the goods being put into a central depot or warehouse and subsequently issued to the various selling departments as required, the system of departmental accounts as here considered will not be suitable and one of the various methods of branch accounts should be applied.

LEDGER ACCOUNTS

The departmental analysis of the entries in the Bought and Sold Day Books does not affect the postings to the Bought and Sold Ledgers, as there should preferably be only one account for each supplier and one for each customer.

The reason for this is that suppliers will normally render one monthly statement of account to the business as a whole against which payment will be made. On the Sales Ledger side, customers will normally expect

PURCHASES

			Dept. A	Dept. B	Dept. C
Jan. 31	To Goods	BDB	2,012 6 8	3,191 10 11	1,826 7 3
	Transfers	TJ	270 17 4	316 7 10	
Feb. 28	etc., etc.				
			£25,618 6 6	£27,921 2 8	£18,635 3 9

to receive one monthly statement showing the total amount due from them; this is most easily prepared from one ledger account which records all the sales to a particular customer. In fact, where book-keeping machines of the type which produce the statement as a carbon copy of the ledger account (or vice versa) are used, no other system would be possible. Credit control also makes it desirable that the total indebtedness of any one customer should be readily ascertainable.

The analysis of the entries in the Day Books (or the use of separate Day Books for each department) is used, therefore, only for the purpose of completing the double entry by the posting of monthly totals to the General Ledger. Where there are comparatively few departments, the appropriate nominal accounts—Purchases, Sales and Stock—can be written up in columnar form.

Transfers *in* to a department are equivalent to additional purchases on behalf of that department; transfers *out*, on the other hand, are not equivalent to sales (first, because the transfers are presumably recorded at cost price, and secondly because, in any case, there is as yet no sale so far as the business as a whole is concerned).

The monthly totals should, therefore, be posted to the Departmental Purchases Accounts—as a debit where the in transfers exceed the out transfers and as a credit where there is a greater transfer out than in. Alternatively, special nominal accounts can be opened to record such transfers and the balances of these accounts will then be taken into the Trading Account.

If the first method is used and the Purchase Accounts are written up on one page of the ledger, in columnar form, they will appear as in the example below.

Expenses will normally be recorded in the usual way and then apportioned at the end of the year. Where it is possible to identify certain items as relating specifically to one department or another (for instance, rent of premises used exclusively by one department, or departmental salaries or wages) the nominal accounts concerned can be provided with appropriate analysis columns.

ACCOUNT

			Dept. A	*Dept. B*	*Dept. C*
Jan. 31	By Returns	ROB	101 10 2	95 6 8	10 1 11
	Transfers	TJ			587 5 2
Feb. 28	etc., etc.				
			1,219 10 2	1,461 8 7	2,173 9 10
Dec. 31	By Trading A/c		24,398 16 4	26,459 14 1	16,461 13 11
			£25,618 6 6	£27,921 2 8	£18,635 3 9

The completion of Departmental Trading and Profit and Loss Accounts is illustrated by the following example:

Example (a)

The Trading and Profit and Loss Account of Turner & Girton, Ltd., for the six months to June 30 is presented to you in the following form:

Purchases:	£	Sales:	£
New Cycles	12,046	New Cycles (A)	10,021
New Carriers	3,021	New Carriers (B)	4,027
Renovated Cycles	672	Renovated Cycles (C)	1,062
Salaries and Wages	2,062	Receipts from	
Rent and Rates:		Hire Contracts (D)	892
Showrooms	250	Stocks at June 30	
Workshops (C)	118	New Cycles (A)	306
Sundry Trade Expenses	3,488	New Carriers (B)	590
Balance, Net Profit	99	Renovated Cycles (C)	816
		Hire Cycles	4,042
	£21,756		£21,756

It is desired to prepare departmental accounts for each of the four departments, A, B, C and D mentioned above, and for this purpose the following information is obtained:

(i) New cycles costing £4,100 have been transferred from A to D Departments.

(ii) Salaries and Wages comprise:

	£
Showroom Wages (divisible between A, B and C Departments in ratio 11 : 3 : 1)	1,067
Workroom Wages (Department C)	319
Administration (apportionable in ratio 8 : 4 : 1 : 7)	676

(iii) Sundry Trade Expenses include £488 in respect of new parts (saddles, etc.) for renovated cycles.

(iv) Other expenses are apportionable in the same ratio as administrative salaries and wages.

(*Incorporated Accountants, Inter.*).

TURNER AND GIRTON, LTD.

Departmental Trading and Profit and Loss Accounts
for the 6 months ended June 30

(1) *Departments A (New Cycles) and B (New Carriers)*

	Dept. A £	*Dept. B* £		*Dept. A* £	*Dept. B* £
To Purchases	12,046	3,021	By Sales	10,021	4,027
Gross Profits c/d	2,381	1,596	Transfer to Hire Dept. (D)	4,100	
			Stocks	306	590
	£14,427	£4,617		£14,427	£4,617
To Showroom Expenses:			By Gross Profits b/d	2,381	1,596
Salaries and Wages	783	213			
Rent and Rates	100	50			
Sundry Trade Expenses	1,200	600			
Administrative Salaries and Wages	270	135			
Net Profit	28	598			
	£2,381	£1,596		£2,381	£1,596

(2) *Department C (Renovated Cycles)*

	£	£		£
To Purchases:			By Sales	1,062
Cycles	672		Stocks	816
Parts	488			
		1,160		
Workroom Wages		319		
Workroom Rent and Rates		118		
Gross Profit c/d		281		
		£1,878		£1,878
To Showroom Expenses:	£		By Gross Profit b/d	281
Salaries and Wages	71			
Rent and Rates	12			
		83		
Sundry Trade Expenses		150		
Administrative Salaries and Wages		34		
Net Profit		14		
		£281		£281

(3) *Department D (Hire Cycles)*

		£		£
To Cost of Cycles, transferred from Dept. A	4,100		By Hire Contracts	892
Less valuation at June 30	4,042		Net Loss	541
		58		
Sundry Trade Expenses		1,050		
Administration Salaries and Wages		237		
Showroom Rent and Rates		88		
		£1,433		£1,433

(4) *General Profit or Loss Account*

	£		£
To Net Loss transferred from Departmental Account:		By Net Profits, transferred from Departmental Accounts:	
Dept. D	541	Dept. A	28
Balance, Net Profit	99	Dept. B	598
		Dept. C	14
	£640		£640

This example brings out clearly the practical advantages of Departmental Accounts from the point of view of management and control. The original Profit and Loss Account showed that on the business as a whole a small profit had been made and failed to reveal the substantial loss actually incurred in Department D.

Consideration of the Department D account in the form in which it has now been set out shows that this loss was incurred in spite of the fact that the closing (stock) valuation of the hire cycles was only £58 below the price at which they were transferred from Department A, this being equivalent to a rate of depreciation of under $1\frac{1}{2}$ per cent for six months or 3 per cent per annum. Cycles let out on hire would normally be expected to suffer a high rate of depreciation.

Apart from the possibly inadequate provision for depreciation of the hire cycles it is apparent that the loss in Department D is attributable, primarily, to the very high allocation of Sundry Trade Expenses, £1,050, which in itself exceeds the gross takings of the department. It is, in any case, unsatisfactory that such a large total of Sundry Trade Expenses should be recorded and apportioned to the departments without further analysis. This debit presumably includes a variety of different items and it is not to be expected that the same basis of allocation to departments will be suitable for each of them.

It will be noted that as Departments A and B are carrying on similar trading businesses their accounts are arranged in columnar form. De-

partment C involves an element of manufacture or making up; its Trading Account is, therefore, more in the nature of a Manufacturing Account. Department D, on the other hand, does not make or sell anything; there is, therefore, no gross profit in the ordinary sense.

In this example the only transfers from one department to another were recorded at cost. The difficulties that arise when they are made on any other basis are well illustrated by the following:

Example (b)

A chemical factory comprises three departments. The first, A, produces a product X, part of which is sold and part used by the other departments. Department B works up product X into another product, Y; Department C works up X into another product, Z. Product X is charged between departments at market price (in the current month, £215 per ton). Management expenses, but not selling expenses, are taken as included in the cost, and are apportioned three-fifths to Department A and one-fifth each to B and C.

The following are the particulars of cost, production, etc., relating to the month of May:

	Dept. A	*Dept. B*	*Dept. C*
	£	£	£
Raw materials consumed	18,310	380	860
Wages	3,460	1,530	1,190
Factory power and expenses, etc.	3,870	1,810	1,430
	£25,640	£3,720	£3,480

Consumption of X: Dept. B 32 tons, Dept. C 40 tons.

Output: of X 140 tons, Y 35 tons, Z 50 tons.

			£
Sales:	Product X	61 tons at £215	13,115
	Product Y	35 tons at £310	10,850
	Product Z	$47\frac{1}{2}$ tons at £294	13,965

Management Expenses £1,600. Selling Expenses £2,652.

Prepare accounts showing the departmental profit or loss of each department and also the true net profit of the whole business for the month, assuming no fluctuation in cost or market price.

(*Chartered Accountants, Inter.*).

Departmental Production and Sales Accounts, May

	Dept. A £	Dept. B £	Dept. C £
Raw materials consumed	18,310	380	860
Consumption of X		6,880	8,600
Wages	3,460	1,530	1,190
Factory Power and Expenses	3,870	1,810	1,430
Management Expenses	960	320	320
Cost of Production	£26,600	£10,920	£12,400
Output (tons)	140	35	50
Cost per ton	£190	£312	£248
Selling (or transfer) price per ton	£215	£310	£294

	Dept. A		Dept. B		Dept. C	
	Tons	£	Tons	£	Tons	£
Direct Sales	61	13,115	35	10,850	47½	13,965
Transfers of X at selling price	72	15,480				
	133	28,595	35	10,850	47½	13,965
Cost of products sold or transferred	133	25,270	35	10,920	47½	11,780
Profit		£3,325				£2,185
Loss				£70		
Profit per ton		£25				£46
Loss per ton				£2		

Stock Reserve

	Dept. B Tons	Dept. C Tons
Total production for month	35	50
Total sales for month	35	47½
Increased stocks	Nil	2½

Notes. (1) As Dept. B stocks have not increased, no stock reserve is necessary in respect thereof.

(2) In Dept. C the output of 50 tons represents the working up of 40 tons of product X from Dept. A. The increased stock of 2½ tons, therefore, represents, proportionately, a stock of 2 tons of X in respect of which the Dept. A profit is £25 per ton. The stock reserve must, therefore, be credited with £50 in order to eliminate from the Profit and Loss Account of the business as a whole the unrealized profit that would otherwise be included.

Profit or Loss Account for May

	£		£
To Departmental Loss:		By Departmental Profit:	
Dept. B	70	Dept. A	3,325
Selling Expenses	2,652	Dept. C	2,185
Stock Reserve	50		
Balance, Net Profit	2,738		
	£5,510		£5,510

BRANCH ACCOUNTS (HOME BRANCHES)

The dividing line between departmental accounts and branch accounts is, in some cases, a fine one. Two adjoining shops owned by the same trader or firm, but selling different products, would normally be regarded as departments. Two shops in different streets or in different towns but selling the same type of article would, however, be regarded as branches. In such a case the transactions might all be recorded in one set of books or each branch might keep its own records.

Branches are usually created as extensions or offshoots of an existing business and this gives rise to the conception of a head office and subordinate branches. If all transactions are recorded in one set of books, the place where the books are kept is regarded as the head office. In organizations of the chain-store type all buying will normally be done by a central office and the record of goods so bought and subsequently issued to the branches will naturally be found at the head office.

Many different systems of book-keeping have been evolved to meet the various circumstances of branch accounting. These fall into two main groups:

(1) Where there is only one complete set of books kept at the head office, in which all the branch transactions are ultimately reflected (in total rather than in detail). In such cases the branches will keep such records of cash takings, stock, sundry debtors, and so on, as will enable the branch manager to make to his head office periodical returns from which the branch accounts will then be completed.

Systems of this type are most suitable where the branches are engaged in retail trade, the goods sold at the branches being provided by the head office, where the record of such purchases has to be made in any case. The staff at such branches would not normally be qualified to keep a complete set of books and, further, the fact that all records are kept at the head office, involving the necessity for regular and complete returns from the branch manager, is an important point in the system of control or internal check.

(2) Where the head office and each branch keep separate and complete sets of books from which separate Trading and Profit and Loss Accounts and Balance Sheets can be prepared. The annual accounts of the business as a whole are then prepared by combining the separate accounts. The various sets of books are linked up by Current

Accounts in which transactions between the head office and a branch or between two branches are recorded.

This system is desirable and, in fact, almost essential where each branch is a self-contained unit making its own purchases and paying for them out of its own resources. Such branches will usually be carrying on manufacturing or wholesale operations.

RETAIL BRANCHES

The main principle influencing the design of a system of branch accounts for retail branches is that each branch is an integral part of the business as a whole. Much responsibility is, of necessity, delegated to the branch manager, and to that extent responsibility is divorced from ownership. The function of the branch is to turn into cash goods supplied to it by the head office. The accounts kept at the head office should, therefore, facilitate control of the branch by:

(1) Making it possible to detect (and, therefore, to a large extent, prevent) losses, wastages or even defalcations of goods or cash.

(2) Revealing the net profit or loss of each branch separately instead of merging it into the profit or loss of the organization as a whole.

The first type of control can be achieved comparatively easily when the goods dealt in are normally sold at fixed selling prices which can be determined in advance. By debiting the goods to the branch at this selling price or by keeping a memorandum Stock Control at the head office a fairly close check can be obtained. Where the goods are of a perishable nature, or for any reason it is not possible to fix the selling prices in advance, it will be necessary to rely to a greater extent on the second type of control, any wastage or shortage being revealed, unless very small in amount, by an unexpectedly low profit. In such cases it will be as well to prepare the accounts at frequent intervals and to send independent stocktakers to the branches at least once a year.

BRANCH RETURNS

The record of goods sent to branches will naturally be found at the head office. For this purpose any goods ordered specially for a branch from a supplier who delivers them to the branch are regarded as sent by the head office because the purchase will be recorded and payment made to the supplier by the head office. On the other hand, the record of sales must come from the branches and each manager should, therefore, render a weekly return to the head office.

The head office, besides paying for all goods purchased, will meet many of the larger expenses of the branches (such as rent and rates) by cheque. The smaller branch expenses and the weekly wages or salaries will, nevertheless, have to be paid in cash at the branch. If these payments are made out of takings only the net balance will remain to be remitted to the head office. This complicates the book-keeping and lessens the degree of control that can be exercised over the branch. It is, therefore, better to provide each branch manager with an expense "float" out of which

such payments can be made. The takings can then be banked or otherwise remitted to the head office intact.

Unless the branch is comparatively close to head office, remittances of money will be made by paying into a local branch of the bank, for credit of the head office. For such Branch Credits most banks provide a triplicate paying-in book instead of the more usual duplicate book. Of the three copies of each paying-in slip:

(1) The first is detached and retained by the bank.

(2) The second, having been stamped by the bank cashier, is subsequently detached by the branch manager and sent to his head office with his weekly return.

(3) The third is retained in the paying-in book for reference at the branch.

The weekly return will give particulars (supported by vouchers where possible) of the cash payments made during the week, and on receipt of the return the head office will send the branch manager a cheque for the amount so expended. This the manager will be able to cash at the local branch of the bank under a standing order to pay such cheques.

If any goods are sold on credit the weekly return should contain sufficient information to enable the total debtors of each branch to be recorded at the head office. In some cases it might be desirable to keep the detailed Sales Ledger accounts at the head office, but this would not normally be necessary. The branch must, of course, keep sufficient records to enable each account to be followed up and collected in due course.

The return of cash takings should distinguish between proceeds of cash sales and cash received from credit customers; otherwise credit sales may be brought in twice in error—once when effected and again when received in cash. The total of cash sales plus credit sales then shows at selling price the actual disposal of stock during the week.

The branch return should also give particulars of goods received during the week in sufficient detail to enable agreement to be effected with the head office records. Several days may elapse between the dispatch of goods from the head office warehouse and their receipt at the branch. Any reconciliation of the stock position would require such amounts to be taken into account as goods in transit. Similarly, it may be necessary to take cash in transit into account when reconciling the remittances of cash from the branch.

In addition to the float or imprest to cover cash expenses, each branch is normally started off with a till float, to enable each day's business to open with a reasonable supply of small change. This should be recorded on the return so that its existence is not overlooked and in case any alteration in its amount is found to be necessary.

The exact form of the weekly return will depend on the nature of the business. Although frequent stocktakings are desirable it is not generally possible to make them a normal feature of the return.

The following is a specimen form of return:

....................BRANCH

RETURN for the week ended....................

CASH RECEIVED

	From Cash Sales	*From Credit Customers*	*Total Banked as per Paying-in Slips attached*
Monday			
Tuesday			
Wednesday			
Thursday			
Friday			
Saturday			

GOODS RECEIVED

	From Head Office	*Direct from Suppliers**	
		Name	*Amount*
Monday			
Tuesday			
Wednesday			
Thursday			
Friday			
Saturday			

* *Any invoice or delivery note accompanying or relating to these deliveries should be attached hereto.*

CREDIT SALES

Balance, b/f			Cash Received as above	
Credit Sales				
Monday			Balance, c/f	
Tuesday				
Wednesday				
Thursday				
Friday				
Saturday				

CASH EXPENSES

Balance, b/f Cash received from Head Office				Payments: Salaries Cash Purchases .. .. Balance, c/f		

Till Float £ : :

REMARKS

(Signed)..................Manager.

QUANTITY STOCK CONTROL

When goods are sold at fixed selling prices a very close check upon the accuracy of the takings can be obtained by a system of quantity stock control. The calculations can conveniently be made in a Stock Book ruled as follows:

Description		(1) *No. in stock at beginning of period*	(2) *No. purchased during period*	(3) *Total of (1) and (2)*	(4) *No. in stock at end of period*	(5) *No. sold (3)–(4)*	(6) *Price*	(7) *Value*
Navy Cut Cigarettes	10's	1,000	4,000	5,000	800	4,200	1s. 9d.	36 15 0
	20's	1,500	6,000	7,500	2,400	5,100	3s. 6d.	44 12 6
Gold Flake Cigarettes	10's	800	3,000	3,800	1,100	2,700	1s. 9d.	23 12 6
	20's	1,800	5,000	6,800	1,400	5,400	3s. 6d.	47 5 0
etc.		etc.	etc.	etc.	etc.	etc.	etc.	

Such a Stock Book shows what the takings for a given period ought to have been; this is compared with the amount actually accounted for. A difference is not necessarily attributable to defalcations; it might be due to errors in stocktaking or to special circumstances making it necessary to depart from the fixed selling prices. When there is a general change in the prices of most of the goods (for example, a change in cigarette or tobacco prices due to a Budget) stock should be taken on the day when the new prices become effective.

The fact that a rigid system of stock control such as the foregoing is in force will not in itself prevent errors or frauds but the fact that it is known to be in operation will generally prove a deterrent. The record may also be extremely useful when a loss is suffered by fire or burglary and it is necessary to prove to the satisfaction of an insurance company how much was lost.

ENTRIES IN HEAD OFFICE BOOKS

The nature of the accounts kept in the head office books to record the branch transactions will depend to a certain extent on the system adopted for charging out goods to each branch. There are three distinct methods of pricing such transfers: (1) at cost price; (2) at estimated selling price found by adding a percentage to cost, and (3) at actual selling price.

In each case the value of goods sent to each branch, priced according to the method used, is debited to a Branch Stock Account. Where there are several branches (but not too many to make the method cumbersome) one page in the ledger can be used, with separate columns for each branch.

Where there are no credit sales at branches and the daily takings are banked intact, these lodgments will appear as debits in the head office Cash Book (being entered from the branch returns or counterfoil paying-in slips and subsequently checked against the Bank Statement) and will be posted to the credit of the Branch Stock Accounts. The Cash Book can be provided with additional analysis columns so that these postings can be made in total, monthly.

Where there are credit sales, however, the cash banked should be credited to a Branch Debtors Account. The actual sales at the branch will then be debited to Branch Debtors Account and credited to Branch Stock Account. If the branch takings are not banked intact but are used for the payment of expenses a Branch Cash Account should also be opened.

The various branch expenses, whether paid out of the branch takings or from the branch expense float or directly by cheque from the head office, should be posted to separate Branch Expenses Accounts in the ledger so that Branch Profit and Loss Accounts, as well as Trading Accounts, can be prepared. The use of these accounts for Branch Debtors, Cash and Expenses does not depend in any way on the method of charging the goods to Branch Stock Account; they are merely necessary links in the chain of double-entry book-keeping which leads to the Branch Stock Account being credited with the full value of the branch sales.

COST PRICE METHOD

This is similar in principle to the method used for recording Consignments Outwards (Chapter XV). The Branch Stock Account is debited with the cost of the goods sent to the branch (and conversely credited with any returned by the branch to the head office) and credited with branch sales. Stock values, including goods in transit, if any, are carried down at cost price and the account then shows, in itself, the gross profit actually realized.

Example

Provincial Retailers, Ltd., have branch shops at Liverpool and Birkenhead which are supplied with goods at cost by the head office. All expenses are paid by the head office, the branch shops keeping Sales Ledgers and remitting all cash to the head office daily.

The following figures have been extracted from the returns made by

the branches and from the books of the head office and relate to the year ended December 31:

	Liverpool	*Birkenhead*
	£	£
Book Debts as at January 1	3,150	2,490
Stock at Branches as at January 1	2,100	1,920
Sales—on Credit	9,613	10,222
for Cash	4,517	7,079
Sales Returns and Allowances	76	82
Cash Received from Customers	9,360	9,902
Bad Debts written off	120	90
Goods supplied by Head Office	8,997	11,403
Rent, Rates and Insurances	456	872
Salaries and General Expenses	2,406	3,990
Stock at Branches at December 31	2,512	1,524

You are required to prepare Trading and Profit and Loss Accounts in respect of each branch shop for the year ended December 31, and to show the other accounts relating to the branches as they will appear in the books of the head office after incorporation of the profit or loss for the period. (*Chartered Accountants, Inter.*).

PROVINCIAL RETAILERS, LTD.

Branch Stock Accounts

	Liverpool	*Birkenhead*		*Liverpool*	*Birkenhead*
		£		£	£
To Balances b/f	2,100	1,920	By Cash Sales	4,517	7,079
Goods	8,997	11,403	Branch Drs. A/cs, Credit Sales	9,613	10,222
Branch Drs. A/cs, Returns	76	82	Balances c/f	2,512	1,524
Branch P. & L. A/cs Gross Profit	5,469	5,420			
	£16,642	£18,825		£16,642	£18,825

Branch Debtors Accounts

	Liverpool	*Birkenhead*		*Liverpool*	*Birkenhead*
	£	£		£	£
To Balances b/f	3,150	2,490	By Returns	76	82
Sales	9,613	10,222	Cash	9,360	9,902
			Bad Debts	120	90
			Balances c/f	3,207	2,638
	£12,763	£12,712		£12,763	£12,712

Branch Expenses Accounts

	Liverpool £	Birkenhead £		Liverpool £	Birkenhead £
To Cash:			By Branch Profit & Loss A/cs	2,982	4,952
Rent, Rates and Insurances	456	872			
Salaries and General Expenses	2,406	3,990			
Branch Drs. A/cs Bad Debts	120	90			
	£2,982	£4,952		£2,982	£4,952

Goods sent to Branches Account

	£		£
To Transfer to Trading A/c	20,400	By Branch Stock A/cs	
		Liverpool	8,997
		Birkenhead	11,403
	£20,400		£20,400

Branch Profit and Loss Accounts

	Liverpool £	Birkenhead £		Liverpool £	Birkenhead £
To Salaries and General Expenses	2,406	3,990	By Gross Profit	5,469	5,420
Rent, Rates and Insurances	456	872			
Bad Debts	120	90			
Net Profit	2,487	468			
	£5,469	£5,420		£5,469	£5,420

In the foregoing example no Branch Cash Accounts were necessary as takings were remitted intact and all expenses were paid by the head office. The Goods Sent to Branches Account receives the credit entries corresponding to the debits in the Branch Stock Accounts for the goods sent to the branches, and at the end of the year is closed by transfer to Trading Account. The head office Trading Account is thus relieved of the cost of the goods sent to the branches.

COST-PLUS-PERCENTAGE METHOD

This should not be used unless there is a fairly constant rate of gross profit on the sale of goods by the branches. As the cost of the goods is known, the effective entries in the head office books are the same as those

made when the cost price method is used. The provision of additional (memorandum) selling price columns in the Branch Stock Account enables the actual stock at the branch, when taken, to be compared with the expected value as shown by the Stock Account.

Example (a)

The Newchester branch of Retailers (Cash Stores), Ltd., submits monthly returns to its head office. The summarized results for the six months ended August 31, were as follows:

	£
Goods received from Head Office	11,900
Cash remitted to Head Office	12,200
Goods returned to Head Office	400
Allowances made to Customers	120
Stocks on Hand—March 1	4,000
August 31	3,200

All goods are invoiced by the head office to the branch at selling price (based on cost plus $33\frac{1}{3}$ per cent). Cash is remitted daily to the head office, by which all expenses are paid.

Show the Newchester Branch Account in the books of the head office for the six months. (*Chartered Accountants, Inter.*).

RETAILERS (CASH STORES), LTD.

Newchester Branch Account

19—		*Selling Price* £	£	19—		*Selling Price* £	£
Mar. 1	To Balance, b/f	4,000	3,000	Mar./Aug.	By Cash	12,200	12,200
Mar./Aug.	Goods	11,900	8,925		Returns	400	300
Aug. 31	Difference (addl. profit)	20			Allces. to customers	120	
	Gross Profit		2,975	Aug. 31	Balance c/d	3,200	2,400
		£15,920	£14,900			£15,920	£14,900

Notes. (1) The relative entries in Goods Sent to Branches Account would be as follows:

Goods Sent to Branches Account

19—		£	19—		£
Mar./Aug.	To Newchester Branch A/c	300	Mar./Aug.	By Newchester Branch A/c	8,925
Aug. 31	Trading A/c	8,625			
		£8,925			£8,925

This account, as before, serves the function of relieving the head office Trading Account of the cost of the goods sent to the branch.

(2) The only *effective* entries (that is, those which are part of the double-entry system of book-keeping) in the Branch Account

are those in the main columns. The figures in the inner columns headed Selling Price are of a memorandum nature only and are not reflected by double entries in other accounts.

(3) The credit for cash received represents the *net* sales to customers after deducting the allowances amounting to £120; consequently the main columns show the gross profit actually realized after crediting the net sales and the £120 does not appear as an actual entry in the books. It is, however, credited in the Selling Price column since it helps to explain why the sales have been less than they would otherwise have been.

(4) The difference then appearing on the Selling Price column, being an excess of credits over debits, shows that the selling prices actually realized (before making certain allowances to customers) have exceeded the estimated selling prices by £20. This is *prima facie* evidence that there has been no loss or defalcation involving either stock or till money during the period under review. It is inserted in the account to enable it to be ruled off, but as it is in the memorandum column only it does not have to be transferred to any other account.

(5) The gross profit, as before, is transferred to the credit of the branch Profit and Loss Account.

An alternative method of book-keeping is to incorporate the selling price figures in the double entry by crediting the estimated gross profit to a Stock Adjustment Account. The function of this account is to carry forward the gross profit in suspense until it is known to have been realized.

Example (*b*)

X, Y, Z & Co. was a partnership whose business consisted of merchanting; the ratio of gross profit to sales was 25 per cent. The head office of the firm was in London and there was a branch in Hull. No books were kept at Hull other than a Debtors Ledger, which was controlled by a Debtors Total Account at the head office. All cash was banked at Hull for credit of the head office and all disbursements for Hull were made by the head office.

At April 1 (the commencement of the financial year), the following balances stood in the head office books after the books had been closed:

	£
Hull Branch Stock A/c (at selling price)	400
,, ,, Stock Adjustment A/c (credit balance)	100
,, ,, Rent and Expenses A/c (credit balance re March quarter rent)	24
,, ,, Debtors Total Account	1,000
,, ,, Discount A/c	25

During the year ended March 31 the following Hull transactions were recorded:

	£
Goods invoiced pro forma to Hull from Head Office at selling price	12,000
Cash Sales	500
Credit Sales	10,000
Cash received from Debtors	9,600
Discount allowed to Debtors	246
Hull expenses paid	2,500

You are required: (i) To show the entries in the head office books. (ii) To close the relevant accounts as at March 31.

Notes. (1) Show clearly the gross profit on Sales.

(2) Provide for $2\frac{1}{2}$ per cent discount on Debtors and £56 for rent and other branch expenses owing.

(3) The Branch Manager took stock on March 31 at selling price which amounted to £1,600.

(4) There was a fire during the year and certain uninsured goods were destroyed. (*Chartered Accountants, Inter.*).

X, Y, Z & Co.

Hull Branch Stock Account

		£			£
April 1	To Balance b/f	400	April/ Mar.	By Cash—Cash Sales	500
April/ Mar.	Goods	12,000		Branch Debtors–Credit Sales	10,000
			Mar. 31	Balance c/f	1,600
					12,100
				Goods destroyed by fire Cost transferred to P. & L. A/c	225
				Gross Profit, written back to Adjustment A/c	75
		£12,400			£12,400

Sasita

Hull Branch Stock Adjustment Account

		£			£
Mar. 31	To Hull Branch Stock A/c re goods destroyed by fire	75	April 1	By Balance b/f	100
	Profit & Loss A/c	2,625	April/ Mar.	Hull Branch Stock A/c (25 per cent on £12,000)	3,000
	Balance c/f (25 per cent on £1,600)	400			
		£3,100			£3,100

Hull Branch Debtors Account

		£			£
April 1	To Balance b/f	1,000	April/ Mar.	By Cash	9,600
April/ Mar.	Hull Branch Stock A/c Sales	10,000		Discount	246
			Mar. 31	Balance c/f	1,154
		£11,000			£11,000

Hull Branch Rent and Expenses Account

		£			£
April/Mar.	To Cash	2,500	April 1	By Balance b/f	24
Mar. 31	Balance c/f	56	Mar. 31	Profit & Loss A/c	2,532
		£2,556			£2,556

Goods Sent to Branch Account

		£			£
Mar. 31	To Trading A/c	9,000	April/Mar.	By Hull Branch Stock A/c	9,000

Hull Branch Discount Account

		£			£
April/Mar.	To Branch Debtors A/c	246	April 1	By Balance b/f	25
Mar. 31	Balance (2½ per cent on £1,154)	29	Mar. 31	Profit and Loss A/c	250
		£275			£275

Hull Branch Profit and Loss Account

		£			£
Mar. 31	To Branch Expenses A/c	2,532	Mar. 31	By Adjustment A/c—Gross Profit realized	2,625
	Branch Discount A/c	250		General Profit and Loss A/c—Net Loss at Branch	382
	Branch Stock A/c—Cost of goods destroyed by fire	225			
		£3,007			£3,007

Notes. (1) All the entries in the Branch Stock Account are at selling price. Consequently the stock on March 31 is valued at selling price and carried forward as a debit balance on Branch Stock Account. This selling price valuation of the stock, however, is known to include a gross profit "loading" of 25 per cent that has not yet been realized. 25 per cent of £1,600 = £400 is therefore carried forward as a credit balance on the Branch Stock Adjustment Account. The difference between these two balances, £1,200, is the true cost price of the branch stock and as such it is taken into the Balance Sheet.

(2) After carrying forward the balance of £1,600 on Branch Stock Account there remains an excess of debits over credits amounting to £300. This must, in this case, be the selling price of the uninsured goods lost in the fire, no other explanation of any stock shortage being given. The cost of these goods was therefore 75 per cent of £300 = £225, which is the amount that is written off to Branch Profit and Loss Account. The other £75 is the anticipated gross profit on these goods which was never realized and is therefore written back to the Branch Stock Adjustment Account.

SELLING PRICE METHOD

If the cost of the goods sent to and sold at a branch is not known it is obviously impossible to prepare a Trading Account for that branch by any ordinary method of book-keeping. It is, however, possible to bring the branch sales and stock figures (taken, for this purpose only, at cost price) into one combined Trading Account for the business as a whole. If it is desired to prepare separate Profit and Loss Accounts for the head office and branches a reasonable approximation can be obtained by apportioning the total gross profit in proportion to turnover and separating the expenses in the usual way.

Example

J. W. Wells is a retail trader carrying on business at a head depot in London, with branches in Birmingham and Manchester. All purchases are made in London. Goods sent to branches are invoiced at selling prices. All cash received by the branches is paid into a local bank daily for the credit of the head office, which is advised weekly of the total sales.

Sales on credit are recorded in Sales Ledgers kept at the branches, and returns of all Sales Ledger transactions are made weekly to the head office, where a Total Debtors Account is kept. Most of the expenses are paid directly by the head office, but the branches are supplied with cash on the imprest system for any expenses which are paid locally.

Any goods returned to the head depot are credited to the branches at selling price. Sales at less than invoiced prices are reported to the head office and the branches are credited with the difference.

The following figures have been extracted from the London Books at December 31:

	London	*Birmingham*	*Manchester*
	£	£	£
Stock at January 1, at selling prices	—	1,500	1,800
Stock at January 1, at cost (London and Branches)	5,700		
Goods sent to Branches		12,000	14,000
Goods returned by Branches		180	120
Purchases	28,000		

(*continued overleaf*)

Extract (continued)

	London	*Birmingham*	*Manchester*
	£	£	£
Sales—Cash	10,000	8,000	9,000
,, Credit	2,500	3,500	5,400
Debtors, January 1	250	300	450
Bad Debts		20	40
Cash Received from Debtors	2,400	3,200	5,500
Expenses	1,500	1,300	1,400
Leasehold Premises	7,000		
Fixtures and Fittings	3,000		
Creditors	2,500		
Bank Balance	1,460		
Cash in Hand	100	50	50
Capital, January 1	11,760		
Drawings	1,800		

On taking stock at selling prices shortages were disclosed at Birmingham £80, and Manchester £120, the greater part of which was accounted for by allowances to customers reported to the head office. After allowing for these shortages, the stock at cost prices at London and Branches at December 31 amounted to £4,900.

Provision is to be made for amortization of Leasehold Premises and for depreciation of Fixtures and Fittings at 10 per cent.

From the foregoing information you are required (1) to write up the accounts with the branches and the Total Debtors Account in the London books; and (2) to prepare Trading and Profit and Loss Account for the year ended December 31 and Balance Sheet as at that date.

(*Chartered Accountants, Inter.*).

J. W. WELLS

Branch Stock Accounts

19—		*Birmingham*	*Manchester*	19—		*Birmingham*	*Manchester*
Jan. 1	To Balance b/f	1,500	1,800	Jan./Dec.	By Goods Returned	180	120
Jan./Dec.	Goods	12,000	14,000		Cash Sales	8,000	9,000
					Credit Sales	3,500	5,400
					Allces. from fixed selling prices	80	120
				Dec. 31	Balances c/f	1,740	1,160
		£13,500	£15,800			£13,500	£15,800

Branch Debtors Account

19—		*Birmingham* £	*Manchester* £	19—		*Birmingham* £	*Manchester* £
Jan. 1	To Balance b/f	300	450	Jan./Dec.	By Cash	3,200	5,500
Jan./Dec.	Sales	3,500	5,400		Bad Debts	20	40
					Balances c/f	580	310
		£3,800	£5,850			£3,800	£5,850

Goods Sent to Branches

		Birmingham £	Manchester £			Birmingham £	Manchester £
19— Jan./Dec.	To Goods Returned	180	120	19— Jan. 1	By Balances b/f	1,500	1,800
	Allces. from selling prices	80	120	Jan./Dec.	Goods	12,000	14,000
Dec. 31	Trading A/c Branch Sales	11,500	14,400				
	Balances c/f	1,740	1,160				
		£13,500	£15,800			£13,500	£15,800

Total Debtors (London)

		£			£
19— Jan. 1	To Balance b/f	250	19— Jan./Dec.	By Cash	2,400
Jan./Dec.	Sales	2,500	Dec. 31	Balance c/f	350
		£2,750			£2,750

General Trading Account for the year ended December 31

		£			£
To Stock, Jan. 1, at cost		5,700	By Sales:		
Purchases		28,000	Head Office	12,500	
Gross Profit (allocated in proportion to turnover):			Birmingham	11,500	
Head Office	3,125		Manchester	14,400	
Birmingham	2,875				38,400
Manchester	3,600		Stock, Dec. 31, at cost		4,900
		9,600			
		£43,300			£43,300

Profit and Loss Accounts for the year ended December 31

	Head Office £	Birmingham £	Manchester £		Head Office £	Birmingham £	Manchester £
To Expenses	1,500	1,300	1,400	By Gross Profit	3,125	2,875	3,600
Bad Debts		20	40				
Net Profit c/d (Subject to depreciation)	1,625	1,555	2,160				
	£3,125	£2,875	£3,600		£3,125	£2,875	£3,600

General Profit and Loss Account

	£		£
To Amortization of Leases	700	By Net Profits b/d:	
Depreciation of Fixtures and Fittings	300	Head Office	1,625
Net Profit, carried to Capital Account	4,340	Birmingham	1,555
		Manchester	2,160
	£5,340		£5,340

Balance Sheet as at December 31

	£	£		£	£
J. W. Wells, Capital A/c:			Leasehold Premises:		
	£			£	
As at Jan. 1	11,760		As at Jan. 1	7,000	
Add Net Profit	4,340		*Less* Amortization	700	
					6,300
	16,100				
Less Drawings	1,800		Fixtures and Fittings:		
		14,300	As at Jan. 1	3,000	
Creditors		2,500	*Less* Depreciation	300	
					2,700
			Stock at cost		4,900
			Sundry Debtors		1,240
			Cash at Bank		1,460
			Cash in Hand		200
		£16,800			£16,800

Note. In the absence of information as to the value of the leasehold premises and fixtures and fittings at each branch, depreciation has been charged against the combined net profits. It should preferably have been calculated separately for the head office and each branch.

BOOKS KEPT BY BRANCHES

Where the size or nature of the business carried on at a branch is sufficient to justify the services of a competent branch book-keeper, the branch will keep a full set of books which will be quite distinct from the books kept at the head office. These books will include accounts recording branch stocks, purchases, sales and expenses from which periodical Profit and Loss Accounts can be prepared.

The branch current assets and liabilities will also be recorded in the branch books since they are affected by the day-to-day transactions involving purchases and sales. Fixed assets on the other hand will sometimes be recorded in the head office books, particularly when they are acquired by or paid for by the head office.

A Current Account between head office and branch is necessary to link up the two sets of books and to record transactions between them (for example, goods sent from head office to branch or cash remitted from branch to head office, or vice versa). In the head office books, the branch Current Account represents the "investment" of the head office in the branch, while in the branch books the corresponding balance standing to the credit of Head Office Account is really the equivalent of proprietor's capital.

Just as, in a sole trader's books, drawings made by the proprietor during the year are accumulated in detail in a separate Drawings Account and then transferred to the debit of his Capital Account at the end of the year, so, in the branch books, it is not unusual to record remittances to the head office in a separate account. This is an advantage if any adjustment is likely to be necessary for cash in transit at the end of the year, when the account will be closed by transfer to Head Office Account.

Similarly, just as the profit of a sole trader is transferred from his Profit and Loss Account to the credit of his Capital Account, so the branch net profit is transferred from Branch Profit and Loss Account to the credit of Head Office Account in the branch books. Converse entries are, of course, necessary in the head office books.

Where goods pass from head office to branches, or vice versa, the transactions should not be regarded as ordinary purchases and sales but should be recorded in a Goods Sent to Branches Account in the head office books and a Goods Received from Head Office Account in the branch books. Such transactions are preferably recorded at cost price in order to avoid an overvaluation of the branch stocks. The fact that separate books are kept at the branch does not alter the fundamental principle that a profit is not made by a mere internal transfer.

Example

D. Woods owns a retail business comprising a head office in Bristol with branches at Taunton and Exeter. All buying is done by the head office, which invoices goods to the branches at cost. Each branch keeps complete double-entry books (all fixed assets, however, being transferred at the end of the year to the head office books), and prepares its own Profit and Loss Account. The following are the Trial Balances extracted from the three sets of books as on December 31, 1952:

	Bristol		*Taunton*		*Exeter*	
	Dr. £	*Cr.* £	*Dr.* £	*Cr.* £	*Dr.* £	*Cr.* £
D. Woods,						
Capital, Dec. 31, 1951		15,000				
Current A/c, Dec. 31, 1951		1,432				
Drawings	2,500					
Taunton Current A/c	2,180					
Exeter " "	2,127					
Head Office Current A/cs				2,108		1,927
Fixed Assets, Dec. 31, 1951						
Bristol	1,560					
Taunton	920					
Exeter	1,040					
Fixed Assets, bought 1952			60			
Stocks, Dec. 31, 1951	4,712		2,432		2,208	
Goods sent to Branches:						
Taunton		5,634				
Exeter		6,637				
Goods from Head Office			5,562		6,637	
Debtors and Creditors	1,314	1,106	407	136	672	172
Purchases, net	22,199					
Sales, net		13,592		8,498		9,810
Salaries and Wages	2,030		960		1,010	
Rent and Rates	950		570		660	
Sundry Trade Expenses	560		475		505	
Bank and Cash Balances	1,309		276		217	
	£43,401	£43,401	£10,742	£10,742	£11,909	£11,909

For the purpose of preparing final accounts the following information and instructions are given to the accountant:

(1) Stocks on hand on December 31, 1952, were: Bristol £5,404, Taunton £2,317 and Exeter £2,433 (excluding goods in transit).

(2) Depreciation is to be provided at 5 per cent on all fixed assets.

(3) The head office is to make a charge of £250 against each branch for administrative services.

(4) The differences between the balances of the corresponding Current Accounts are due to goods forwarded from head office to Taunton not having arrived there on the balancing date and a cheque from Exeter to head office being in the post.

You are required to set out:

(1) The three Trading and Profit and Loss Accounts for the year (in columnar form) and the Balance Sheet of the business as on December 31, 1952.

(2) The Head Office Current Account as it would appear in the Taunton books showing the closing entries, and

(3) A Trial Balance showing the balances remaining in the Taunton books after all the closing entries have been made.

(*Chartered Accountants, Inter.*).

D. WOODS

Trading and Profit and Loss Accounts for the year ended December 31, 1952

	Bristol	*Taunton*	*Exeter*		*Bristol*	*Taunton*	*Exeter*
	£	£	£		£	£	£
To Stocks, Jan. 1, 1952	4,712	2,432	2,208	By Sales, net	13,592	8,498	9,810
Purchases, net	22,199			Goods sent to Branches	12,199		
Goods received from Head Office		5,562	6,637	Goods in transit to Branch	72		
Gross Profits, carried down	4,356	2,821	3,398	Stocks, Dec. 31, 1952	5,404	2,317	2,433
	£31,267	£10,815	£12,243		£31,267	£10,815	£12,243
To Salaries and Wages	2,030	960	1,010	By Gross Profits, brought down	4,356	2,821	3,398
Rent and Rates	950	570	660	Charge to Branches for administration services	500		
Sundry Trade Expenses	560	475	505				
Head Office charge administration services		250	250				
Depreciation	78	49	52				
Net Profits, carried to General Profit and Loss A/c	1,238	517	921				
	£4,856	£2,821	£3,398		£4,856	£2,821	£3,398

General Profit and Loss Account for the year ended December 31, 1952

	£		£	£
To Transfer to D. Woods' Current A/c	2,676	By Net Profits:		
		Bristol	1,238	
		Taunton	517	
		Exeter	921	
				2,676
	£2,676			£2,676

Balance Sheet as at December 31, 1952

	£	£		Bristol £	Taunton £	Exeter £	£
Capital Account		15,000	Fixed Assets:				
Current Account:			As at Jan. 1, 1952	1,560	920	1,040	
As at Jan. 1, 1952	1,432		Additions		60		
Add Net Profit	2,676			1,560	980	1,040	
	4,108		*Less* Depreciation	78	49	52	
Less Drawings	2,500			1,482	931	988	3,401
		1,608	Stocks	5,404	2,317	2,433	10,154
Sundry Creditors:			Goods in Transit				72
Bristol	1,106		Debtors	1,314	407	672	2,393
Taunton	136		Cash in Transit				200
Exeter	172		Bank and Cash Balances	1,309	276	217	1,802
		1,414					
		£18,022					£18,022

Head Office Current Account (in Taunton Books)

		£			£
1952 Dec. 31	To Fixed Assets acquired during year	60	1952 Dec. 31	By Balance b/f	2,108
	Balance c/d	2,864		Depreciation of Fixed Assets (recorded in H.O. books)	49
				H.O. charge for administration	250
				Net Profit	517
		£2,924			£2,924

Trial Balance of Taunton Books

	Dr. £	Cr. £
Head Office Current Account		2,864
Stock	2,317	
Debtors	407	
Creditors		136
Cash and Bank Balances	276	
	£3,000	£3,000

Notes. (1) The Taunton Current Account in the head office books will be closed by entries corresponding to those shown

above and in addition will record the goods in transit, which account for the different balances appearing in the two sets of books, namely:

Taunton Current Account

1952		£	1952		£
Dec. 31	To Balance b/f	2,180	Dec. 31	By Fixed Assets	60
	Depreciation of Fixed Assets	49		Goods in Transit c/d	72
	Management Charge	250		Balance c/d	2,864
	Net Profit	517			
		£2,996			£2,996
1953					
Jan. 1	To Balance b/d	2,864			
	Goods in Transit	72			

(2) Cash in Transit, £200, will similarly be carried down as an additional balance on Exeter Current Account.

(3) The final balance of £2,864 represents the *net assets* of the Taunton branch in so far as they are recorded in the branch books, namely:

	£
Stock	2,317
Debtors	407
Cash and Bank	276
	3,000
Less Creditors	136
	£2,864

(4) As it is the practice in this business to record all the fixed assets in the head office books, the £60 expended at Taunton during this year and temporarily recorded in the Taunton books has to be transferred into the head office books via the Current Accounts.

(5) As the fixed assets are recorded in the head office books but the depreciation written off them is a charge against the branch profits, it has to be transferred back from the head office books to the branch books via the Current Accounts. The head office charge for administration gives rise to a similar transfer.

If it is not possible or desirable to transfer goods from the head office to branches at their original cost price, it will be necessary to create a Stock Reserve in the head office books in order to eliminate any unrealized profit that would otherwise be included in the valuations of the branch stocks. The Trading Accounts will then show the results of trading on the basis of transfers at the agreed prices; any variation in the Stock Reserve will be dealt with in the General Profit and Loss Account. This method is suitable where the head office makes up or manufactures the goods and transfers them to its branches at wholesale prices, which would normally be in excess of the original cost.

When head office and branches are situated in different countries it will usually be essential to keep a separate set of books at each branch. These will, of necessity, be written up in the appropriate foreign currency, in which all the branch transactions are effected.

Although, from the point of view of control, the branches should make frequent returns to the head office of their current transactions, the actual trading accounts will normally be incorporated in the head office books once a year. For this purpose the branch book-keeper will balance his books and send a Trial Balance to his head office. The figures in this will, of course, be in local currency. Before they can be incorporated in the head office books they must be converted into sterling.

The primary object served by converting the branch currency figures is to enable the branch assets and liabilities to appear, together with the corresponding head office items, in the Balance Sheet of the business as a whole. The principles involved are, therefore, primarily those which govern the valuation of assets and liabilities for Balance Sheet purposes. All the items in the branch Trial Balance will fall into one or other of the following groups and should be converted accordingly.

Current Assets and Liabilities. As realizable value is an important factor in the valuation of such items, the rate of exchange ruling on the date of the Balance Sheet should be employed.

Opening Stock. As a corollary to the foregoing, as the opening stock in one year was the closing stock in the previous year, the rate ruling at the beginning of the year (that is, on the date of the Balance Sheet in which this stock appeared as an asset) should be employed.

Fixed Assets and Depreciation thereon. Fixed assets are normally valued at cost, less depreciation. The object of writing off depreciation being to spread the original cost over the expected working life, to secure consistent figures in the Balance Sheets the rate of exchange ruling when the assets were acquired should be adopted throughout their life.

Profit and Loss items. These relate to the year as a whole and are, therefore, converted at the average rate of exchange for the year except in so far as any other rate is fixed by the foregoing rules. (For example: depreciation at the rate applicable to the assets concerned; Stocks at the opening and closing rates; Provision for Bad Debts at the rate applicable to the debtors.)

The balances on Head Office Current Account and (where applicable) Remittances to Head Office Account will not normally require to be converted as their equivalents appear in the head office books as balances on Branch Current Account and Remittances from Branch Account respectively. Care must be taken to allow for values in transit, however, before assuming that the figures are equivalent.

The first step in preparing the Trading and Profit and Loss Account and Balance Sheet of the whole business is to draw up a Converted Trial Balance. The sterling columns of this cannot be expected to agree where

the currency figures are converted at several different rates. If an amount has to be inserted on the debit side to make the sterling columns agree it is a loss on exchange and should be written off either to Profit and Loss Account or to Exchange Reserve if one exists.

On the other hand, a profit on exchange arises when the debit side exceeds the credit side and an amount, therefore, has to be entered on the credit side to bring the totals into agreement. A profit on exchange should normally be carried forward in reserve and not taken to credit of Profit and Loss Account.

From that point onwards the procedure is similar to that used for home branches which keep their own books. In the Branch Current Account in the head office books it is generally convenient to show the currency figures in addition to their sterling equivalents.

Example

The Alumite Manufacturing Co., Ltd., prepared the following Trial Balances of its Head Office in London and of its Factory in Atalanta as on June 30, 1945:

	London		*Atalanta*	
	£ *Dr.*	£ *Cr*	*Bengoes Dr.*	*Bengoes Cr.*
Share Capital, Authorized and Issued: 45,000 shares of £1 each		45,000		
Goodwill and Patents	15,000			
Premises			56,000	
Plant and Machinery			92,000	
Furniture and Fittings			12,500	
Stock, July 1, 1944			36,000	
Sundry Debtors			100,120	
Cash at Bank	3,600		22,980	
Sundry Creditors				97,800
Provision for Taxation		4,000		
Profit and Loss Account, July 1, 1944		7,600		
Branch Current Account, July 1, 1944	38,600			
Head Office Current Account, July 1, 1944				199,500
Wages			176,000	
Purchases			97,200	
Sales				528,000
Factory Expenses			80,000	
Office Expenses	1,000		50,400	
Selling Expenses			25,600	
Directors' Fees	500			
Taxes Paid	3,600			
Remittances from Branch		10,200	76,500	
Dividends paid	4,500			
	£66,800	£66,800	B. 825,300	B. 825,300

The following charges for depreciation are to be taken into account: Premises, 3 per cent; Plant and Machinery, 10 per cent; Furniture and Fittings, 5 per cent.

Carry forward a provision of £6,000 for taxation.

The stock at the Branch at June 30, 1945, was 94,000 Bengoes.

The following rates of exchange were operative during the year:

July 1, 1944	3s. 4d. per Bengoe
June 30, 1945	2s. 0d. ,, ,,
Average rate for the year	2s. 6d. ,, ,,
Average rate of remittances	2s. 8d. ,, ,,

and the rate at which the fixed assets were purchased was 4s. per Bengoe.

From the above particulars you are required to prepare:

(1) Branch Current Account.

(2) Trading and Profit and Loss Account of the Branch.

(3) Profit and Loss Account in the London books.

(4) Balance Sheet as on June 30, 1945.

Note. "Atalanta" and "Bengoes" are assumed names.

(*Chartered Accountants, Final*).

Before the required accounts can be prepared the Branch Trial Balance must be converted into sterling.

ATALANTA BRANCH

Converted Trial Balance as on June 30, 1945

	Dr. Bengoes	*Cr.* Bengoes	*Rate*	*Dr.* £	*Cr.* £
Premises	56,000		4s. 0d.	11,200	
Plant and Machinery	92,000		4s. 0d.	18,400	
Furniture and Fittings	12,500		4s. 0d.	2,500	
Stock, July 1, 1944	36,000		3s. 4d.	6,000	
Sundry Debtors	100,120		2s. 0d.	10,012	
Cash at Bank	22,980		2s. 0d.	2,298	
Sundry Creditors		97,800	2s. 0d.		9,780
H.O. Current A/c, July 1, 1944		199,500	Actual		38,600
Wages	176,000		2s. 6d.	22,000	
Purchases	97,200		2s. 6d.	12,150	
Sales		528,000	2s. 6d.		66,000
Factory Expenses	80,000		2s. 6d.	10,000	
Office Expenses	50,400		2s. 6d.	6,300	
Selling Expenses	25,600		2s. 6d.	3,200	
Remittances	76,500		2s. 8d.	10,200	
	825,300	825,300		£114,260	£114,380
Loss on Exchange				120	
Stock, June 30, 1945	94,000	94,000	2s. 0d.	9,400	9,400

Atalanta Branch Current Account

	Bengoes	£		Bengoes	£
To Balance b/f	199,500	38,600	By Remittances	76,500	10,200
Branch Profit	145,295	13,449	Loss on Exchange	—	120
			Balance c/d	268,295	41,729
			(Representing)— B. £		
			Premises 54,320 10,864		
			Plant 82,800 16,560		
			F. & F. 11,875 2,375		
			Stock 94,000 9,400		
			Debtors 100,120 10,012		
			Cash 22,980 2,298		
			366,095 51,509		
			Creditors 97,800 9,780		
			268,295 41,729		
	B. 344,795	£52,049		B. 344,795	£52,049

Branch Trading and Profit and Loss Account
for the year ended June 30, 1945

	Bengoes	£		Bengoes	£
To Stock	36,000	6,000	By Sales	528,000	66,000
Purchases	97,200	12,150	Stock	94,000	9,400
Wages	176,000	22,000			
Factory Expenses	80,000	10,000			
Depreciation of Plant	9,200	1,840			
Gross Profit c/d	223,600	23,410			
	B. 622,000	£75,400		B. 622,000	£75,400
To Office Expenses	50,400	6,300	By Gross Profit b/d	223,600	23,410
Selling Expenses	25,600	3,200			
Depreciation: Premises	1,680	336			
Furniture and Fittings	625	125			
Net Profit at Branch	145,295	13,449			
	B. 223,600	£23,410		B. 223,600	£23,410

General Profit and Loss Account

		£			£
To Loss on Exchange		120	By Branch Net Profit		13,449
Head Office Expenses		1,000			
Directors' Fees		500			
Net Profit for the year	c/d	11,829			
		£13,449			£13,449
To Taxation		5,600	By Balance, July 1, 1944	b/f	7,600
Dividends paid		4,500	Net profit for the year	b/d	11,829
Balance	c/f	9,329			
		£19,429			£19,429

Balance Sheet as on June 30, 1945

		£			£	£
Authorized and Issued Share Capital:			Fixed Assets, at cost, less depreciation:			
45,000 Shares of £1 each		45,000			£	
Profit and Loss Account		9,329	Goodwill and Patents		15,000	
		54,329	Premises		10,864	
Current Liabilities:	£		Plant and Machinery		16,560	
Sundry Creditors	9,780		Furniture and Fittings		2,375	
Taxation Reserve	6,000	15,780				44,799
			Current Assets:			
			Stock		9,400	
			Sundry Debtors		10,012	
			Cash at Bank:			
			Atalanta	£2,298		
			London	£3,600	5,898	
						25,310
		£70,109				£70,109

It will be observed that the Branch Trading and Profit and Loss Account had to be written up, both in currency and sterling, before the Branch Account could be balanced by inserting the net profit figures. From the point of view of the head office double-entry book-keeping system, the Branch Trading and Profit and Loss Account was merely a "working paper" necessary to calculate the net profit, which was then brought into the books by one double entry (Dr. Branch Current Account, Cr. General Profit and Loss Account).

It is sometimes considered necessary to record the branch transactions in the head office books in greater detail; the individual items are then entered in the Branch Account as follows:

Atalanta Branch Current Account

	Bengoes	£		Bengoes	£
To Balance b/f	199,500	38,600	By Remittances	76,500	10,200
Sales	528,000	66,000	Loss on Exchange		120
Stock, June 30, 1945	94,000	9,400	Stock, July 1, 1944	36,000	6,000
Creditors c/d	97,800	9,780	Purchases	97,200	12,150
			Wages	176,000	22,000
			Factory Expenses	80,000	10,000
			Office Expenses	50,400	6,300
			Selling Expenses	25,600	3,200
			Depreciation:		
			Premises	1,680	336
			Plant and Machinery	9,200	1,840
			Furniture and Fittings	625	125
			Assets c/d		
			Premises	54,320	10,864
			Plant and Machinery	82,800	16,560
			Furniture and Fittings	11,875	2,375
			Stock	94,000	9,400
			Debtors	100,120	10,012
			Cash at Bank	22,980	2,298
	B. 919,300	£123,780		B. 919,300	£123,780
To Balance b/d (Net)	268,295	41,729			

The method of converting the branch currency figures illustrated in the foregoing example is suitable where the rate of exchange is subject to fluctuations. Where the rate of exchange is relatively stable from one end of the year to the other it may alternatively be decided to convert all the branch figures at one rate of exchange. Small profits or losses on exchange will then arise if remittances are effected at rates varying slightly from this fixed rate.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) A company is formed to operate a number of retail stores. The directors decide that all supplies should be purchased by the head office and sold by the branches at such prices as would show a gross profit of 33⅓ per cent on the original cost. It is suggested by the directors that the branch managers be allowed to pay all branch expenses out of cash takings and that in approved cases credit be given to customers.

Discuss the decision of the directors and criticize their suggestions. Further, outline a system of accounting which you would recommend, appending a brief set of rules to be followed by the branch managers with an explanation of the reason for each rule, for the information of the directors. (*C.I.S. Inter.*).

(2) From the following information show the approximate net profits of the three departments, namely, FU, IR and PR of the England and Wales Stores, Ltd., for the three months ended June 30.

	FU	IR	PR
	£	£	£
Stock at April 1	4,500	5,250	2,250
Purchases for the three months	5,250	4,875	3,525
Sales for the three months	9,000	7,500	4,500
Expenses (direct) for the three months	1,515	1,100	530

The total expenses (indirect) for the three months, which include those relating to other departments, were £3,150 on total sales of £63,000. The expenses are charged in proportion to the turnover of the department.

Stock was not taken on June 30, but the usual rates of gross profit for the three departments in question are—FU, 35 per cent; IR, 40 per cent; and PR 30 per cent. Provision for Bad Debts is to be made, namely, 1 per cent on turnover of each department. (*A.C.C.A. Inter.*).

(3) The following transactions relate to the Leeds Branch of a multiple trading company for the year ended December 31:

	£		£
Stock at January 1	19,200	Credit Sales	36,900
Sundry Debtors, January 1	15,000	Cash received from Debtors	41,700
Cash in hand, January 1	18	Stock at December 31	13,800
Goods received from Head Office	56,400	Sundry Debtors, December 31	9,600
Cash Sales	24,900	Cash in hand, December 31	54

Goods are invoiced to the branch at selling price, namely, 33⅓ per cent above cost. The head office pays all expenses except petty cash payments, a cheque for £60 each month being sent to the branch for this purpose. The branch expenses during the year paid by head office were: Salaries and Wages £4,200, and Rent, Rates, etc., £1,800.

Write up the branch accounts and also Profit and Loss Account in the head office books for the year, after writing off £600 for Bad Debts.

(*A.C.C.A. Inter.*).

(4) M, Ltd., is a multiple-shop company. All goods sold at the shops are supplied from the head office, invoiced at selling price. The head office keeps records of all branch transactions in the form of total accounts for each branch, written up from periodical returns. The ratio of gross profit to sales is fixed at 25 per cent.

From the data given below, which relate to the Q branch, you are required to write up the following accounts as they would appear in the head office books:

Q Branch Stock Account (at selling price)

Q Branch Stock Adjustment Account (to record differences between cost and selling price)

Branch Debtors' Account

	£	£
Stock, February 1 (at selling price)	1,168	
Add Goods from Head Office (at selling price)	996	
		2,164
Less—Cash sales	675	
Credit sales	217	
Stock lost (not accounted for)	4	
		896
Stock, February 28		1,268
Debtors, February 1	96	
Add Credit Sales	217	
		313
Less Cash received		178
Debtors, February 28		135
Summary of payments for February—		
Wages		135
Sundry Expenses		26
		161

You are also required to draw up a statement showing the net profit earned by the branch for the month of February, assuming that the monthly proportion of the branch rent (paid by head office) is £32. (*L.C. of C. Higher*).

(5) X was sole proprietor of a garage. He owned the buildings and charged the business a rent of £100 per annum. The Trial Balance at December 31, 1948, was:

	£		£
Purchases:		Sales:	
Cars, new and second-hand	10,500	Cars, new and second-hand	10,011
Petrol	3,000	Petrol	3,415
Materials, including Tyres, Accessories, etc.	1,127	Tyres, Accessories, etc.	1,252
Stock of Petrol, Dec. 31, 1947	100	Repairs	4,107
Stock of Materials, including Tyres and Accessories, Dec. 31, 1947	400	Capital Account	5,266
Cost of Motor Showroom built during 1947	1,388		
Furniture	400		
Plant	3,000		
Wages, Mechanics	2,163		
,, Petrol Pump Attendants	194		
,, Office	419		
Rates, Insurance, etc.	253		
Rent to Sept. 29, 1948	75		
Office Expenses, etc.	920		
Balance at Bank	110		
Cash in hand	2		
	£24,051		£24,051

You are also given the following information:

(*a*) Rates £140 per annum were paid to March 31, 1949.

(*b*) Depreciation is to be provided at 15 per cent per annum on Plant (all used for repair work) and 5 per cent per annum on Furniture.

(*c*) Stocks at December 31, 1948, were: Cars, £1,560; Petrol, £85; Materials, including Tyres and Accessories, £320.

(*d*) Materials used on repair jobs cost £250.

(*e*) Petrol used on demonstration runs cost £45.

(*f*) Mechanics' time on reconditioning second-hand cars cost £150.

(*g*) The Manager is entitled to 10 per cent commission on the profits after charging such commission.

You are required to prepare a Trading and Profit and Loss Account for the year ended December 31, 1948, in a form most useful to the proprietor, and a Balance Sheet as at that date. Ignore shillings and pence.

(*Chartered Accountants, Inter.*).

(6) South Coast Stores, Ltd., have an authorized capital of £100,000, all in Ordinary shares of £1. The company owns shops at Brighton (the head office), Eastbourne and Worthing. The following were the Trial Balances extracted from the books as on September 30, 1949:

	Head Office		*Eastbourne*		*Worthing*	
	Dr. £	*Cr.* £	*Dr.* £	*Cr.* £	*Dr.* £	*Cr.* £
Issued Capital: (75,000 Shares fully paid)		75,000				
4 per cent Debentures		15,000				
General Reserve		8,000				
P. & L. Account, Sept. 30, 1948		595				
Stocks, Sept. 30, 1948	8,522		4,608		4,270	
Purchases	22,043		17,330		14,744	
Sales		31,007		25,922		21,383
Trade Debtors	5,932		4,120		3,572	
Trade Creditors		1,218		52		119
Freehold Premises	55,000					
Fixtures and Fittings	2,300					
Discounts	612		504		461	
Salaries and Wages	2,115		1,560		1,350	
Interim Dividend paid	3,000					
Motor Vans, Sept. 30, 1948	6,200					
Motor Vans bought, Dec. 31, 1948	2,100					
Eastbourne	3,187					
Worthing	3,712					
Head Office				3,187		3,712
Postage and Stationery	355		133		110	
Trade Expenses	764		593		536	
Directors' Fees	1,000					
Advertising	1,930					
Van Running Expenses	2,341					
Debenture Interest	675					
Cash	9,032		313		171	
	£130,820	130,820	29,161	29,161	25,214	25,214

(*a*) Prepare the company's Trading and Profit and Loss Accounts for the year ended September 30, 1949, and Balance Sheet as on that date, making adjustments in accordance with the following information:

(i) Stocks on hand on September 30, 1949, were as follows: Brighton, £9,217; Eastbourne, £4,202; Worthing, £4,332.

(ii) The motor vans are to be depreciated at the rate of 20 per cent per annum and the Fixtures and Fittings at 5 per cent, the debits for depreciation to be charged equally to head office and each branch.

(iii) Provision is to be made for Trade Expenses outstanding as follows: Brighton £170: Eastbourne £32: Worthing £19.

(iv) Stationery and Stamps on hand at head office (only) on September 30, 1949, were valued at £37.

(v) Ignore Income Tax.

(*b*) Prepare a statement showing the balances standing in the Worthing books as on September 30, 1949, after the closing entries have been made.

(*L.C. of C. Higher*).

(7) Merchants, Limited, has a branch office in South Wales which obtains supplies partly from head office at cost and partly from outside suppliers. The branch keeps a separate set of books but does not prepare a Profit and Loss Account or Balance Sheet.

On April 30, 1949, the following Trial Balances were extracted:

	Head Office		*Branch*	
	£	£	£	£
Share Capital				
30,000 Shares of £1 each		30,000		
Fixed Assets	16,000		8,000	
Profit and Loss Account at May 1, 1948		4,000		
Opening Stocks at cost	14,000		1,900	
Debtors	17,000		1,500	
Creditors		10,000		2,050
Cash and Bank Balances	3,000		1,000	
Purchases, less Returns	120,000		6,750	
Sales, less Returns		140,000		20,500
Sundry Expenses	15,000		2,250	
Goods from Head Office to Branch		12,000	11,500	
Current Accounts at April 30, 1949	11,000			10,350
	£196,000	196,000	32,900	32,900

The difference between the balances on the head office and Branch Current Accounts is due to goods and cash being in transit at the close of the year.

Fixed assets are to be depreciated at 10 per cent per annum.

Stocks were valued at the close of business on April 30, 1949, as follows: Head Office £10,000, Branch £2,100.

You are required:

(*a*) To prepare columnar Trading and Profit and Loss Accounts for the year for the use of the head office.

(*b*) To close the Head Office and Branch Current Accounts and to show the composition of the final balances thereon, and

(*c*) To prepare a Balance Sheet (not for publication) as at April 30, 1949.

(*Chartered Accountants, Inter.*).

(8) P and Q carry on business as general merchants in London with a branch in Calcutta. Goods supplied by the head establishment to the branch and vice versa are charged at cost, but the branch also makes purchases direct from other suppliers in India and elsewhere. All items in the branch account in the head office books are converted at the rate of exchange ruling on the date of the transaction. The cost price in sterling of the fixed assets in Calcutta may be taken at an average rate of 1s. 6d. per rupee.

EXERCISES

The following are the Trial Balances at December 31, 1948:

	Head Office		Calcutta	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	£	£	Rs.	Rs.
Capital		40,000		
Premises	20,000		35,000	
Fixtures and Fittings	2,250		2,000	
Calcutta Branch Account	11,500			
Calcutta Remittances Account		1,750		
Head Office Account				165,000
Head Office Remittances Account			24,000	
Purchases	23,000		379,000	
Sales		30,000		500,000
Expenses	4,000		80,000	
Sundry Debtors	3,500		60,000	
Sundry Creditors		1,500		25,000
Bills Receivable	1,550			
Bank and Cash Balances	1,450		15,000	
Stock at January 1, 1948	6,000		95,000	
	£73,250	73,250	Rs.690,000	690,000

Stock at December 31, 1948: London £5,500, Calcutta Rs. 97,500.

The rates of exchange have been:

January 1, 1948	1s. 5d. per rupee
December 31, 1948	1s. 6d. „ „
Average for the year	1s. 6d. „ „

Prepare Profit and Loss Account for the year and Balance Sheet at December 31, 1948, for the head establishment and the branch and for the whole business. Provide depreciation at 5 per cent on the premises, fixtures and fittings. Provision for Doubtful Debts: 5 per cent on debtors at head office, 10 per cent on those at Calcutta. (*Chartered Accountants, Inter.*).

(9) John Jones & Co. have their head office in London, and a branch in New York. A separate set of double-entry books is kept at the New York branch. The following particulars are extracted from the two sets of books:

	£
New York Branch Account (in Head Office Books) January 1, 1949	10,000 (Dr.)
Cash remitted from Head Office to New York during 1949	1,250
Goods invoiced from New York to Head Office	4,127
New York Profit and Loss Account—Loss for 1949	1,254
Loss on Exchange on conversion of New York Trial Balance, December 31, 1949	42

You are required to show the New York Branch Account in the head office books from January 1 to December 31, 1949, assuming that head office makes up its Balance Sheet on December 31 each year. Bring down a balance on the account at December 31, 1949. (*Chartered Accountants, Inter.*).

CHAPTER XVIII

GOODS ON SALE OR RETURN: PACKAGES: HIRE-PURCHASE

SALE OR RETURN

IN some trades it is customary to send out goods on sale or return (or on approval), while in others such transactions may be met with occasionally. The customer who receives goods on these terms has the right to elect, during a certain limited period, whether to keep or return the goods. If he does not return them within the period specified (or in a reasonable time, if no period was specified) he is deemed to have accepted them. He is not usually liable to make any payment to the supplier until he has either accepted the goods or failed to return them.

The amount payable if the goods are kept is normally indicated by sending with them a pro-forma or "appro." invoice. If the goods are returned this may be evidenced by the issue of a pro-forma credit note. Neither of these documents should be regarded, by either party, as having any direct bearing on the purchase and sale of goods.

From the point of view of the trader who sends out goods on sale or return, the accounting principles involved are in some respects similar to those already met in connexion with consignments and branch accounts. Goods have left the trader's shop or warehouse but have not, as yet, been sold. If the transaction were treated as an ordinary sale, credit would be taken for a profit that has not yet been realized. Such goods are, in fact, still part of the trader's stock-in-trade, for although possession of them may have passed to his customer, the legal property in them has not yet passed.

Some record must, of course, be made; otherwise the trader might never get paid for goods sent out on approval and not returned by the customer. Further, if the transaction is not recorded as a sale and the goods have not been returned before the Balance Sheet date it will be necessary to bring them into the valuation of stock-in-trade; the records kept must be such as will enable this to be done.

The two principal methods of achieving this result are as follows.

MEMORANDUM (STOCK BOOK) RECORD

Unless sale or return transactions are very numerous or involve goods of considerable value (such as jewellery) this is generally the most satisfactory system. A ruling of general application is shown on page 443. This has the advantage that when goods are retained by customers the entry in the Goods Retained column constitutes a Day Book, from which the appropriate posting can be made into the Sales Ledger.

The provision of an additional Balance column is of assistance in totalling and ruling off the book periodically. The outstanding transac-

tions are then carried down and re-entered on the first page for the next period, so that the subsequent sale or return of these goods can be recorded in the usual way.

If carbon copies of the pro-forma invoices and credit notes are kept and filed in the order of the entries in the Sale or Return Book, they will constitute part of the record and it will not be necessary to enter any details in the book other than the dates, names and amounts. When valuing the stock of goods out on sale or return, the pro-forma invoices will be referred to for quantities and descriptions of the goods in question, but the price at which they are valued for stocktaking will normally be cost price and not the selling price shown on the pro-forma invoice.

SALE OR RETURN LEDGER

Where the sale or return transactions are numerous or involve goods of considerable value, and several amounts are likely to be outstanding against one customer at any given time, a more comprehensive system with a ledger account for each customer (not to be confused with his account in the Sales Ledger) is to be preferred. By the operation of a Total or Control Account such a ledger can be balanced periodically.

SALE OR RETURN BOOK

Date	*Name*	*Details*	*Value*	*Goods Returned*		*Goods Retained*			*Out-standing on....*
				Date	*Value*	*Date*	*Fo.*	*Value*	
19— June 2	A	See Invoice	80 0 0	19— June 9	80 0 0				
4	B	" "	112 10 0			June 25	SL2	112 10 0	
7	C	" "	63 6 8	June 11	33 6 8	June 11	SL10	30 0 0	
11	D	" "	57 10 0						57 10 0
15	A	" "	98 9 6			June 20	SL6	98 9 6	
22	E	" "	41 3 4						41 3 4
			£452 19 6		£113 6 8			£240 19 6	£98 13 4
								GL92	
19— b/f July 1	D	June 11 b/d	57 10 0						
	E	22 b/d	41 3 4						

Notes. (1) The only column which constitutes part of the double-entry system of book-keeping is that which shows the value of goods retained by customers. This is posted in detail to the debit of the customers' accounts in the Sales Ledger and in total to the credit of Sales Account in the General Ledger.

(2) The outstanding transactions, £98 13s. 4d. at selling price, will be revalued at cost and brought into account as stock-in-trade.

The prime entries from which the Sale or Return Ledger is posted, will be as before:

(1) Goods sent out on sale or return.
(2) Goods returned by customers.
(3) Goods retained by customers (that is, sold to them).

But instead of recording all these in one Day Book it is better to keep:

(1) A Sale or Return Day Book recording the pro-forma invoice values of the goods sent out on sale or return, and

(2) A Sale or Return Journal, used when the goods are *either* returned *or* retained in order to credit the account in the Sale or Return Ledger and, where the goods are retained, to debit the account in the Sales Ledger proper.

By using these two books it is possible to make all the entries in each in chronological order and, therefore, to total and rule off each page as it is completed.

Example

On January 1 P and Q had in hand goods sent to them on sale or return and invoiced pro-forma at £40 and £90 respectively. P returned his goods on January 3, while Q elected to keep his on January 10. During January goods were sent out on sale or return as follows:

			£
Jan.	3	R	50
	10	Q	35
	12	S	67
	18	T	42

R returned his goods on January 18 and S elected to keep his on the 28th. The other transactions were outstanding at the end of the month.

Make the appropriate entries in the Sale or Return Day Book and journal respectively, post to the Sale or Return Ledger and agree the balances on the latter with its Control Account.

Sale or Return Day Book

Date	*Name*	*Fo.*	*Amount*
19—			£
Jan. 3	R	3	50
10	Q	2	35
12	S	4	67
18	T	5	42
			£194
			(6)

Sale or Return Journal

Date	*Name*	*S or R Ledger*	*Returned*	*S or R Ledger*	*Sales Ledger*	*Retained*
19—			£			£
Jan. 3	P	1	40			
10	Q			2	S.L.	90
18	R	3	50			
28	S			4	S.L.	67
			£90			£157

Sale or Return Ledger

P (*Fo.* 1)

	£		£
Jan. 1 To Bal. b/f	40	Jan. 3 By Ret.	40

Q (*Fo.* 2)

	£		£
Jan. 1 To Bal. b/f	90	Jan. 10 By Sale	90
10 Goods	35	31 Bal. c/d	35
Feb. 1 To Bal. b/f	35		

R (*Fo.* 3)

	£		£
Jan. 3 To Goods	50	Jan. 18 By Ret.	50

S (*Fo.* 4)

	£		£
Jan. 12 To Goods	67	Jan. 28 By Sale	67

T (*Fo.* 5)

	£		
Jan. 18 To Goods	42		

Control A/c (*Fo.* 6)

	£		£
Jan. 31 To Ret.	90	Jan. 1 By Bal. b/f	130
Sales	157	31 Goods	194
Bal. c/f	77		
	£324		£324
		Feb. 1 By Bal. b/f	77

Trial Balance

	Dr.	Cr.
Q	35	
T	42	
Control A/c		77
	£77	£77

Note. The accounts of Q and S in the ordinary Sales Ledger will be debited with £90 and £67 respectively.

ISOLATED TRANSACTIONS

Where it is not customary to send goods out on sale or return in the ordinary course of business but certain customers are, nevertheless, on occasion allowed to have goods on approval, it will probably be found that these transactions will be treated as ordinary sales (and, of course, as returns if the goods are not accepted by the customer). The opening of special sale or return books would not be justified in such cases and if at the date of the Balance Sheet no such transactions are open, no further action is necessary. If it is found, however, that the schedule of Sales Ledger balances at the date of a Balance Sheet includes one or more of such items, correcting entries should be made as follows:

(1) The total amount involved, at selling price, should be carried down as a credit balance on Sales Account, before it is closed by transfer to Trading Account. The effect of this is to reduce the credit for sales in the Trading Account by the amount of the outstanding sale or return transactions.

The credit balance on Sales Account is treated as a deduction from the total of the Sales Ledger balances and thus reduces the item Sundry Debtors in the Balance Sheet by a like amount.

(2) The cost of the goods in question is ascertained and is added to the valuation of stock-in-trade.

This increases the credit to Trading Account for closing stock and increases the stock valuation in the Balance Sheet by a like amount.

The net effect of the two correcting entries is to eliminate from the Trading Account the gross profit included in the price at which the goods were invoiced (by pro-forma) to the customer.

Example

Upon examining the Sales Ledger of X, a trader, it is found that a balance of £300 due from Y on December 31 was in respect of goods sent to him on sale or return on December 28. The cost of these goods was £240. X's Trading Account for the year ended December 31 before correction was as follows:

	£		£
To Stock, Jan. 1	5,000	By Sales	30,000
Purchases	25,500	Stock, Dec. 31	6,000
Gross Profit	5,500		
	£36,000		£36,000

The corrected Trading Account will show the following result:

	£			£
To Stock, Jan. 1	5,000	By Sales		29,700
Purchases	25,500	Stock in hand	£6,000	
Gross Profit	5,440	Stock out on sale or return	240	
				6,240
	£35,940			£35,940

It will be seen that the effect of the correction is to reduce the gross profit by £60, that being the difference between the selling price and the cost price of the goods out on sale or return.

GOODS RECEIVED ON SALE OR RETURN

Goods which a trader has received on sale or return for the purpose of disposing of them to his own customers are not his property. He should not treat them as purchases or stock until:

(1) he has notified his intention of keeping them, or

(2) the period during which he was entitled to return them has expired, or

(3) he has sold them to one of his own customers (a fact which he must, of course, notify to the suppliers, as it is now no longer possible to return the goods and he is, therefore, liable to pay for them).

When one of these events has occurred, then the purchase of the goods should be recorded in the usual way. Until this has happened, care must be taken not to include the goods in any stocktaking, for if they are credited in the Trading Account as stock-in-trade without being included on the other side in the debit for Purchases, the profit will, to that extent, be overstated.

In some trades a considerable volume of goods may be carried on sale or return and in such cases it will be necessary to maintain an accurate Stock Book so that when a particular article is sold the suppliers of it can be identified and advised.

Where a Stock Book is not kept and the transactions are few in number it may be better to ignore the principles set out above and to enter the pro-forma invoice in the books as though the goods had been purchased outright. If the goods are subsequently returned the appropriate entry will be made in the Returns Outwards Book. At a Balance Sheet date any such outstanding transactions should preferably be deducted from purchases and closing stock in the Trading Account and from creditors and stock in the Balance Sheet. The profit will not be affected, however, if this adjustment (which is designed to prevent an overstatement of the assets and liabilities) is ignored.

PACKAGES

Packages may be either an essential part of the saleable product (for example, the packets in which cigarettes are sold to the public) or a distribution expense incurred in bulk dispatch (for example, the cartons and boxes in which packets of cigarettes are dispatched to the retailer). They may be the subject of a separate charge to the customer or may be included in the price of the articles which they contain. They may be returnable or non-returnable. If they are charged for but returnable the credit given when they are returned may be for the whole or only part of the original charge.

Except when the package is unreturnable, a separate charge for it is clearly not a sale in the ordinary sense. The packages may be returned (if it is the intention that they should be) and the charge will then be cancelled. The principles of goods sent out on sale or return are, therefore, involved, in some degree, in accounting for returnable packages.

NON-RETURNABLE PACKAGES

If packages are non-returnable, and, therefore, will not be available for use again, the cost of providing them may be substantial and should be recorded separately in the books. When closing the books at the end of the year the following distinction may be drawn:

(1) Packages which are an essential part of the finished article, in the form in which it will eventually be sold to the public (for example, bottles of hair cream), are regarded as part of the cost of making up the product and their cost is debited in the Manufacturing Account, if one is prepared, or otherwise in the Trading Account.

(2) Crates and cartons used for sending out supplies of the product to

wholesalers or retailers (or for export) are regarded as selling or distribution expenses and are charged in the Profit and Loss Account proper.

In each case stocks of containers or packages on hand at the end of the year should be brought into account as an asset. As such stocks will represent unused packages they can be valued at cost price unless they have deteriorated, when they should be written down accordingly.

Packages falling into the first category become merged in the finished article and are not likely to be the subject of a separate charge to the customer. Crates and cartons in the second category, however, may be used in varying degree according to the size of the order and the distance to which it has to be sent. If charges are made to customers for packing, the amounts so recovered should preferably be extended into a separate column in the Sales Day Book so that they can be credited to Packages Account instead of to Sales. The same principle applies when additions are made to sales invoices for carriage or postage.

RETURNABLE PACKAGES

If packages are returnable but are not made the subject of a charge (and, therefore, no credit note is given when they are returned), it will be necessary only to keep some memorandum record of the packages sent to each customer so that they can be "followed up" if they are not returned in a reasonable time.

The double-entry book-keeping system will not concern itself with the sending out and the recovery of the packages; it will, however, record the cost of acquiring them as and when they have to be replaced or added to. As in the case of non-returnable packages, the amount to be written off to Profit and Loss Account will be the opening stock, plus purchases of new packages and less the closing stock of them. The stocks will include many used packages in various stages of repair, which should not be valued at more than a fraction of their original cost. It would be permissible to take into account packages in the hands of customers, not yet returned, but a substantial deduction should be made to cover packages that never will be returned.

It is generally found that in the absence of a financial inducement in the form of a charge that will have to be paid for any package that is not returned, the average life of a package is comparatively short. Some customers will not return them at all and others may treat them so badly that they soon become useless.

The chief advantage of the method is, in fact, its simplicity, because the Sales Ledger, with its attendant work of preparing invoices and monthly statements, is kept free from a mass of detailed entries relating to packages sent out and returned.

Modern book-keeping machines and similar aids make it easier to deal with a large number of entries and, therefore, facilitate the introduction and carrying out of a system of charging for packages. This has the two-fold advantage of:

(1) encouraging customers to return packages promptly, and
(2) shifting the cost of the package to the customer if he keeps it.

A charge for a returnable package is similar, in some respects, to a pro-forma invoice for goods sent out on sale or return. It is, however, the intention that a package shall be returned, whereas goods are sent out on sale or return in the hope that the customer will keep them. Further, the charge for a package is generally linked up with the charge for the goods contained in it and it will often be convenient to make both charges on the same invoice. Thus, although it would be possible to have a separate set of Package Books similar to those devised for Goods Out on Sale or Return, this would generally be inadvisable.

The provision of an additional Packages column in the Sales Day Book makes it possible to include the package charges in the ordinary debit postings to the Sales Ledger but to exclude them from the monthly credits to Sales Account. The Returns Inwards Book can also be provided with a separate column for packages or alternatively a separate Packages Returns Book can be used. In a large concern the latter is to be recommended, as the credit notes for returned packages will be issued by the Packing Department whereas other credit notes originate in the Sales Department.

The monthly totals of the Package columns in the Sales Day Book and Returns Inwards Book (or Packages Returns Book) will be credited and debited respectively to a Package Charges Suspense Account in the General Ledger. Provided the amount credited to a customer on return of a package is the same as the original charge for it, the credit balance on the Packages Charges Suspense Account represents the value (at the prices at which they are charged to customers) of packages that have been sent out and not yet returned.

By deducting this credit balance from the total of the Sales Ledger debit balances, the net amount due from customers for goods sold to them is found. This, subject to any necessary provision for bad and doubtful debts, is the correct amount to carry into the Balance Sheet as Sundry Debtors. The packages that have, in this way, been excluded from Sundry Debtors will then be valued at cost less depreciation and brought into account as part of the total stock of packages. Only a very low valuation would normally be placed upon them.

Periodically, a detailed schedule of Sales Ledger balances should be prepared showing in separate columns the amount due from each customer for (1) goods and (2) packages. It will probably be found that the total amount due for packages is less than the credit balance on Package Charges Suspense Account at that date, because some customers have retained and paid for packages. The difference should be adjusted by a transfer from Package Charges Suspense Account to Packages Account, since it represents a sale of packages to the customer.

Example

Packages which cost a merchant 8s. each are charged to his customers at 10s. each and credited in full upon return to him. On April 1 he had a stock of 200 used and 500 unused packages in his warehouse, while 800 packages were in the hands of his customers on that date. During the year ended March 31, 6,000 returnable packages were sent out to

customers and 4,800 were returned by them; 2,000 new packages were purchased at a cost of 8s. each. On March 31 the stocks were: unused packages in warehouse 400; used packages in warehouse 600; packages in hands of customers not yet returned or paid for 1,400.

For Balance Sheet purposes unused packages are valued at cost, while used packages, whether in the warehouse or in the hands of customers, are valued at 2s. each.

Write up the Package Charges Suspense Account and the Packages Account and explain the significance of the net cost of packages to the merchant, written off to Profit and Loss Account.

PACKAGE CHARGES SUSPENSE ACCOUNT

19—		No.	£	19—		No.	£
April/ Mar.	To Sundries	4,800	2,400	April 1	By Balance b/d	800	400
Mar. 31	Packages A/c	600	300	April/ Mar.	Sundries	6,000	3,000
	Balance c/d	1,400	700				
		6,800	£3,400			6,800	£3,400
				April 1	By Balance b/d	1,400	£700

PACKAGES ACCOUNT

19—		No.	£	19—		No.	£
April 1	To Stock b/f Unused	500	200	Mar. 31	By P.C.S. A/c	600	300
	Used	200 800	100		P. & L. A/c	500	440
					Stock c/d Unused	400	160
April/ Mar.	Sundries	2,000	800		Used	600 1,400	200
		3,500	£1,100			3,500	£1,100
April 1	To Stock b/d	2,400	£360				

The transfer of £440 from Packages Account to Profit and Loss Account is the net cost to the merchant for the year ended March 31 of providing packages necessary to distribute his products. It can be explained as follows:

New packages, which cost 8s. each, were drawn upon during the year, as follows:

Stock on April 1	500
Purchased	2,000
	2,500
Less Stock on March 31	400
	2,100

Of these customers retained	600	at 10s. each, a *profit* of 2s. per case	=	£ 60 Cr.
The increased stock of used packages, including returnable packages, held by customers was 2,000 − 1,000 =	1,000	which, being valued at only 2s. a case, involve a loss of 6s. per case	=	300 Dr.
The remainder were lost or became unfit for further use	500	involving a loss of 8s. per case	=	200 Dr.
	2,100			£440 Dr.

As 6,000 packages were actually used during the year for sending out goods to customers (this includes a large number which were returned and used again) the cost of providing new packages for each order would have been 8,000 at 8s. = £3,200, which would have had to be met by the merchant if he had made no charge for packages or by his customers if he had charged them for non-returnable packages. The difference between £3,200 and the actual net cost of £440 to the merchant plus £300 to his customers for packages not returned represents a saving of £2,460.

In some trades, packages returned by customers will have to be thoroughly cleaned and renovated before they can be used again and in such cases it is not unusual to credit the customers with less than the amount originally charged for each package. The balances on Package Charges Suspense Account will then have to be valued at the lower prices to be credited on return, and this, coupled with the difference in the prices at which the main debit and credit entries in the Suspense Account are made, will give rise to a larger profit to transfer to the credit of Packages Account. This profit will be offset by the cost of cleaning and renovating which should be debited to Packages Account.

Example

In the same circumstances as those illustrated in the preceding example, except that customers are credited with only 5s. per package returned and the cost of cleaning and renovating returned packages amounted to £1,250, the ledger accounts will be as follows:

PACKAGE CHARGES SUSPENSE ACCOUNT

19—		No.	£	19—		No.	£
April/ Mar.	To Sundries	4,800	1,200	April 1	By Balance b/d	800	200
Mar. 31	Packages A/c	600	1,650	April/ Mar.	Sundries	6,000	3,000
	Balance c/d	1,400	350				
		6,800	£3,200			6,800	£3,200
				April 1	By Balance b/d	1,400	350

PACKAGES ACCOUNT

		No.	£			No.	£
19—				19—			
April 1	To Stock b/f	1,500	300	Mar. 31	By P.C.S. A/c	600	1,650
April/ Mar.	Sundries:				P. and L. A/c	500	340
	New Packages	2,000	800		Stock c/f	2,400	360
	Cleaning, etc.		1,250				
		3,500	£2,350			3,500	£2,350
April 1	To Stock b/f	2,400	360				

Notes. (1) The details of the stock valuations in Packages Account are as in the preceding example.

(2) The transfer of £1,650 from Package Charges Suspense Account to Packages Account represents:

		£
10s. per case on	600 cases not returned	300
5s. „ „ „	5,400 cases returned or returnable	1,350
	6,000	£1,650

HIRE-PURCHASE ACCOUNTS

A hire-purchase agreement is an agreement under which one party (the owner) agrees to let the other party (the hirer) have the use of certain goods in return for periodical payments for a limited term. At the end of that term the hirer is deemed to have purchased the goods outright or has the option to do so upon payment of a further nominal sum. Pending completion of the periodical payments he can terminate his liability by returning the goods; subject to any special provision in the agreement and subject to there being no instalments in arrear, his liability is then at an end.

Although the hirer has the possession and use of the goods during the currency of the agreement, the legal property in them is not yet his, so that he is not entitled to dispose of them to a third party without the consent of the owner. A trader, therefore, does not normally acquire goods in this way unless they are of a type suitable for use as fixed assets in the business (for example, plant or motor lorries); obviously goods required as stock, for resale, could not be so acquired. Where a trader has not sufficient capital resources to buy new plant outright, the hire-purchase system does afford a convenient method of paying for the plant out of the additional profits which it is hoped it will enable him to earn.

From the point of view of the seller, the system is one which promotes sales by allowing extended credit. This involves some additional risk of bad debts which is not entirely obviated by the seller's right to recover the goods if the purchaser defaults in his instalment payments. Hire-purchase agreements are, therefore, restricted in practice to goods which possess some degree of permanence, such as furniture and motor cars, and the length of the period over which the instalments are to be spread

will depend upon the degree of stability of value of the goods. Thus, three or more years might be reasonable for an agreement relating to a pianoforte, whereas one year or perhaps eighteen months would normally be the limit for a wireless set.

A trader who wishes to allow his customers hire-purchase facilities but has not the necessary capital to finance such transactions himself, may obtain the necessary assistance from hire-purchase finance companies which exist for this purpose. So far as the purchaser is concerned, it is immaterial whether the agreement is entered into with the original seller of the goods or with a finance company which, under the agreement, technically becomes the owner of them. In either case he has obtained the immediate use of the goods without having to pay for them in full. For this convenience he will expect to pay, in total, more than the original cash price of the goods. The difference between the cash price and the total hire-purchase price (including any deposit) is in the nature of interest. This interest will be at a fairly high rate, as it has to reimburse the seller for:

(1) Interest on the capital which is locked up in the form of extended credit.
(2) Additional profit or insurance to cover risk of broken agreements.
(3) Additional expenses incurred in collecting the instalments.

Although the instalments are usually equal in amount, it does not follow that each instalment contains the same amount of interest. On the contrary, as the interest relates to the balance still to be paid, the amount of interest included in each instalment gets less as the balance outstanding is reduced. Conversely, each successive instalment contains a correspondingly greater amount of "capital redemption." The same process is apparent in the ordinary form of building-society mortgage, where redemption is effected by regular instalments which contain both interest and capital.

In an exact calculation, the principles of compound interest are involved and the transaction is similar to an annuity; the cash price of the article being the present value, at a given rate of interest, of the series of payments that will have to be made under the hire-purchase agreement. Except where substantial amounts are involved, however, it is unusual to make complicated calculations of this nature, and the interest is merely expressed as an addition to the cash price, making up the total amount that will be paid by instalments. The result, to the uninitiated, may be misleading, for the average amount outstanding is approximately one half of the original cash price; the effective rate of interest is, therefore, about double the rate quoted as an addition to the price.

Example

Goods which could be bought for £100 cash down are advertised for sale on hire-purchase terms under which a deposit of £2 and 12 monthly instalments of £9 will be payable, making a total of £110.

The addition for interest may be described as 10 per cent on the price of £100, but the *effective* rate is nearly 20 per cent because the *average* amount outstanding during the year is little more than £50.

SALES FOR DEFERRED PAYMENTS

As an alternative to a hire-purchase agreement, goods may be purchased and sold under an agreement which provides for extended credit, payment being made by regular instalments, with interest, on the outstanding balances. In effect, such an agreement may be very similar to a hire-purchase agreement; in legal form it is very different. The legal ownership of the goods as well as the right to take possession and make use of them passes *at once* to the purchaser. He has no right to terminate the contract by returning the goods, and, conversely, his failure to keep up the instalments will not normally give the sellers any right to recover possession of the goods. The form and substance of the agreement is the giving of extended credit; obviously such contracts will only be entered into with purchasers whose credit is good.

For book-keeping purposes, whether the contract is one of hire-purchase or of deferred payment, the substance of the transaction is considered to be more important than the legal form. When the contract is entered into, it is the intention of both parties that it shall be carried through to completion and once all the payments have been made there is no difference in the legal position. The purchaser is now the legal owner of the goods, which have, in fact, been in use in his business since he took delivery of them perhaps two or three years ago. The *use* made of a machine or lorry (and thus the profit earned by it) will be the same, whatever the legal form of the agreement under which it was acquired and paid for.

If a purchaser by deferred payments finds himself unable to keep up the instalments there is nothing to prevent his coming to an arrangement with the seller whereby the latter takes back the goods and forgoes the outstanding instalments. Neither party can be forced to come to such an arrangement, but in certain circumstances it might clearly be in the best interests of both of them to do so.

The book-keeping problems that arise when an agreement is terminated in this way will be similar to those arising when a hire-purchaser is unable to keep up his instalments. Unless the contrary is indicated, therefore, all that follows in this chapter can be regarded as applying equally to deferred payment contracts and hire-purchase agreements.

INTEREST CALCULATIONS

Accurate calculations may be necessary in order to give effect to the correct principles of accountancy in the books of the vendor or the purchaser or both. Five factors are involved:

(1) The cash price of the goods, less any deposit paid on or before signing the agreement.
(2) The rate of interest.
(3) The frequency of the instalments.
(4) The number of instalments.
(5) The amount of each instalment.

If any four of these factors are known (and they are, of course, primarily

a matter for agreement between the parties) the fifth can be found from them by mathematical calculation. No definite calculation is possible unless at least four of the factors have been fixed. Normally it is (5)—the amount of each instalment—that has to be calculated, the other factors being known. As the calculations involve compound interest, the use of interest tables will always assist the calculations, and in some cases (for example, where it is desired to calculate the rate of interest involved in a given transaction) are essential. The various calculations will be illustrated by examples.

CALCULATION OF AMOUNT OF EACH INSTALMENT

This assumes that the instalments, other than the initial deposit, if any, are to be of equal amount. Given a cash price of £1,000, of which £200 was paid as a deposit, the balance to be paid by eight equal half-yearly instalments, with interest at 6 per cent per annum, calculated half-yearly, the amount of each instalment is calculated as follows:

> 6 per cent per annum is equivalent to 3 per cent per half-year and the calculation can, therefore, be made on the basis of eight yearly instalments at 3 per cent per annum. From 3 per cent annuity tables, the present value of an annuity of £1 for eight years is found to be £7·0197. By simple proportion, therefore, £800 is the present value of eight equal instalments of $£\frac{800}{7{\cdot}0197} = 113{\cdot}965 = £113$ 19s. 4d.

The accuracy of this calculation can be checked by working out the annuity in the following table:

Half-year No.	*Balance at commencement* (1) £ s. d.	*Interest at 3 per cent thereon* (2) £ s. d.	*Instalment paid* (3) £ s. d.	*Amount of capital repaid* (3)−(2) £ s. d.
1	800 0 0	24 0 0	113 19 4	89 19 4
2	710 0 8	21 6 1	113 19 4	92 13 3
3	617 7 5	18 10 5	113 19 4	95 8 11
4	521 18 6	15 13 3	113 19 4	98 6 1
5	423 12 5	12 14 2	113 19 4	101 5 2
6	322 7 3	9 13 6	113 19 4	104 5 10
7	218 1 5	6 10 10	113 19 4	107 8 6
8	110 12 11	3 6 5	113 19 4	110 12 11
		£111 14 8	£911 14 8	£800 0 0

Including the original deposit of £200, the total amount paid under the agreement is £1,111 14s. 8d., of which £111 14s. 8d. is interest, while £1,000 is the actual cash price of the article.

CALCULATION OF NUMBER OF INSTALMENTS

If the amount of each instalment is one of the agreed factors, then it will be necessary to calculate the number of instalments which, at the given rate of interest, will discharge the cash price plus interest. As the

answer will generally not be an exact whole number, the final instalment will then differ from the others. Alternatively, the initial deposit can be adjusted to avoid this.

Reference to tables will only give an approximate result, because they are calculated on the basis that all the instalments, including the last, are equal. It is, therefore, simpler to work out a schedule, as in the check of the previous example.

Given a cash price of £1,000, which is to be paid by a deposit of £200 and half-yearly payments of £200 until such time as the principal, plus interest at 6 per cent per annum, calculated half-yearly, has been paid off, the calculation will proceed as follows:

Half-year No.	*Balance at commencement*	*Interest at 3 per cent thereon*	*Instalment paid*
	£ s. d.	£ s. d.	£ s. d.
1	800 0 0	24 0 0	200 0 0
2	624 0 0	18 14 5	200 0 0
3	442 14 5	13 5 8	200 0 0
4	256 0 1	7 13 7	200 0 0
5	63 13 8	1 18 3	65 11 11
		£65 11 11	£865 11 11

Including the initial instalment, or deposit, of £200, the total amount paid under the agreement will be £1,065 11s. 11d., of which £65 11s. 11d. is interest and £1,000 is the actual cash price of the article.

FREQUENCY OF INSTALMENTS

This is a matter for agreement between the parties and is not a subject for calculation. Where retail trade is concerned, monthly or even weekly instalments are the general rule. Commercial agreements involving substantial sums where the credit of the purchaser is good, however, may provide for longer intervals.

CALCULATION OF RATE OF INTEREST

If the rate of interest is not specified in the agreement, the purchaser may have to calculate it in order to record the transaction correctly in his own books. There is no direct or exact method of calculation; the answer has to be found by interpolation between the nearest values revealed by compound interest tables.

Example

Given a cash price of £1,000 and a hire-purchase price of £1,200 payable as to £200 down (deposit) and five half-yearly instalments of £200 each.

Deduct the deposit, £200, from the cash price, £1,000, and the balance, £800, is then the present value, at an unknown rate of interest,

of an annuity of £200 per half-year for five half-years. Or, by simple proportion, 4 is the present value of an annuity of 1.

Reference to annuity tables shows that:

At $7\frac{3}{4}$ per cent the present value is 4·020
At 8 per cent the present value is 3·993.

As the value at 8 per cent is so close to the facts (3·993 differs from 4 only in the third place of decimals) the rate of interest involved in the transaction could, for most practical purposes, be taken at 8 per cent per half-year. If a more accurate result is required it is found by interpolation, the answer lying between $7\frac{3}{4}$ per cent and 8 per cent, approximately in the same ratio that 4 lies between 4·020 and 3·993.

The answer is, therefore:

$$8 - \frac{4{\cdot}000 - 3{\cdot}993}{4{\cdot}020 - 3{\cdot}993} \times {\cdot}25 = 8 - {\cdot}065 = 7{\cdot}935 \text{ per cent per}$$

half-year, which is equivalent to 15·87 per cent per annum, with half-yearly rests.

CALCULATION OF CASH PRICE

It may occasionally be necessary to calculate the cash price when that is the only unknown factor. If annuity tables are not available this can be effected by calculating backwards from the last instalment.

Example

Given that a deposit of £200 is to be followed by four half-yearly instalments of £200 and a final instalment of £65 11s. 11d. and that the rate of interest is 6 per cent per annum, payable half-yearly.

The final payment of £65 11s. 11d. is known to be exactly sufficient to pay off (1) the capital outstanding at the beginning of the last half-year, plus (2) interest on that balance for six months.

For every £100 outstanding at the beginning of the half-year, interest is £3, making a total payment of £103.

Therefore, by simple proportion,

$\frac{3}{103}$ × £65 11s. 11d. = £1 18s. 3d. of the last instalment is interest,

and

$\frac{100}{103}$ × £65 11s. 11d. = £63 13s. 8d. of the last instalment is capital.

Thus, £63 13s. 8d. was the balance outstanding immediately after the fourth instalment of £200 was paid.

The balance at the end of the fourth half-year before the instalment of £200 was paid was, therefore, £263 13s. 8d., which represents the capital outstanding at the beginning of that half-year, plus interest on it at 3 per cent.

Therefore, again by simple proportion:

$\frac{3}{103}$ × £263 13s. 8d. = £7 13s. 7d. of the fourth instalment was interest,

and

£200 less £7 13s. 7d. = £192 6s. 5d. of the fourth instalment was capital, and so on.

If the results of the calculations are entered in a table the final answer is found to be:

Half-year No.	*Capital included in half-yearly instalment* £ s. d.	*Capital outstanding at end of previous half-year before payment of instalment then due* £ s. d.
5	63 13 8	263 13 8
4	192 6 5	456 0 1
3	186 14 4	642 14 5
2	181 5 7	824 0 0
1	176 0 0	—
	800 0 0	
Add Deposit	200 0 0	
Cash price	£1,000 0 0	

ENTRIES IN PURCHASER'S BOOKS

It will be necessary to consider the entries in the books of the purchaser under a hire-purchase agreement only where he is carrying on a business and the goods covered by the agreement are intended for use in that business. In such cases the goods will be fixed assets (that is, they will not be acquired for the purpose of re-sale) but they are also likely to be subject to depreciation. On motor vehicles, which are often bought on hire-purchase terms, depreciation will be at a comparatively high rate.

The book-keeper should look at the substance of the transaction rather than its legal form. Under the agreement the instalments may be described as "hire"; in fact, each instalment is a mixture of principal and interest under which the true cost price of the asset (that is, its cash price—not its total hire-purchase price) is being worked off over a period of months and years. The following general principles should, therefore, be observed:

(1) The interest element of the instalments is not part of the cost of the asset; it is an expense or loss similar to bank interest or interest on loans and should be written off to Profit and Loss Account as it accrues.

(2) The full use of the asset is obtained immediately even though payment for it is deferred. Depreciation should, therefore, be provided for on the same scale as if the asset had been purchased outright.

(3) Until all the instalments have been paid the asset should not appear in the Balance Sheet without some indication that it is subject to a hire-purchase agreement.

The simplest method is as follows:

(1) A personal account is opened either for the original vendors or for the hire-purchase finance company if the agreement is being financed in that way, to which will be credited the original *cash* price of the asset, the double entry being completed by a corresponding debit in the asset account.

(2) The original deposit, if any, and the full amount of each subsequent instalment, when paid, will then be posted from the Cash Book (Cr.) to the debit of this personal account.

(3) Interest at the rate taken into account in the agreement will be credited to the personal account on the due dates of the instalments, being calculated on the balance outstanding at the beginning of that period.

(4) The double entry for the interest will be completed in a Hire-purchase Interest and Charges Account and written off to Profit and Loss Account annually when the books are balanced.

(5) If the books have to be balanced on a date other than one when an instalment becomes due, accrued interest from the last instalment date will be carried down as a credit balance on Interest Account.

Example

On October 1 a trader purchased two motor lorries, cash price £1,000, paying a deposit of £200 and entering into a hire-purchase agreement to pay four half-yearly instalments of £200 and a final instalment of £65 11s. 11d. The rate of interest is known to be 6 per cent per annum.

The trader balances his books on June 30. Depreciation is to be written off at 20 per cent per annum on the cost of the lorries, by the straight-line method.

The relative entries in the trader's ledger will be:

MOTOR LORRIES

19—		£	19—		£
Oct. 1	To Vendors	1,000	June 30	By Profit and Loss Account Depreciation for 9 months	150
				Balance c/d	850
		£1,000			£1,000
July 1	To Balance b/d	850	June 30	By Profit and Loss Account Depreciation	200
				Balance c/d	650
		£850			£850

(Alternatively the depreciation can be accumulated in a separate account.)

HIRE-PURCHASE VENDORS

19—			19—		
Oct. 1	To Cash	200 0 0	Oct. 1	By Motor Lorries	1,000 0 0
Apr. 1	"	200 0 0	Apr. 1	Interest	24 0 0
June 30	Balance c/d	624 0 0			
		£1,024 0 0			£1,024 0 0
Oct. 1	To Cash	200 0 0	July 1	By Balance b/d	624 0 0
Apr. 1	"	200 0 0	Oct. 1	Interest	18 14 5
June 30	Balance c/d	256 0 1	Apr. 1	"	13 5 8
		£656 0 1			£656 0 1
Oct. 1	To Cash	200 0 0	July 1	By Balance b/d	256 0 1
Apr. 1	"	65 11 11	Oct. 1	Interest	7 13 7
			Apr. 1	"	1 18 3
		£265 11 11			£265 11 11

HIRE-PURCHASE INTEREST AND CHARGES

19—			19—		
Apr. 1	To Vendors	24 0 0	June 30	By Profit and Loss A/c	33 7 3
June 30	Balance c/d	9 7 3			
		£33 7 3			£33 7 3
Oct. 1	To Vendors	18 14 5	July 1	By Balance b/d	9 7 3
Apr. 1	"	13 5 8	June 30	Profit and Loss A/c	26 9 8
June 30	Balance c/d	3 16 10			
		£35 16 11			£35 16 11
Oct. 1	To Vendors	7 13 7	July 1	By Balance b/d	3 16 10
Apr. 1	"	1 18 3	June 30	Profit and Loss A/c	5 15 0
		£9 11 10			£9 11 10

In the first Balance Sheet to be prepared for the trader on June 30 following the commencement of the agreement, the motor lorries will appear among the fixed assets:

	£	£
Motor Lorries, at cost	1,000	
Less Depreciation	150	
		850

while the balance of £624 on the Vendor's Account at that date will appear among the liabilities as "Future Instalments under Hire-purchase Agreements." The £9 7s. 3d. accrued interest will be included in the total of accrued expenses.

Alternatively, the outstanding £624 can be deducted from the cost of the asset, which is then shown at the net amount *paid* to date after writing off depreciation and interest, namely:

	£	£
Motor Lorries, at cost	1,000	
Less Hire-purchase instalments not yet due	624	
	376	
Less Depreciation	150	
		226

An alternative method of recording the transaction, which makes it unnecessary to open a personal account for the vendors, is to apportion each instalment between capital and interest, posting the capital portion to the asset account. This has the disadvantage that depreciation cannot then be calculated on the balance of the asset account, as it is still necessary to calculate it on the full cash price.

Example

Journal entries applied to the facts of the foregoing example, for the first year only, would be as follows:

Oct. 1	Motor Lorries Dr. To Cash being deposit on purchase of 2 lorries under h.p. agreement.	200 0 0	200 0 0
Apr. 1	Motor Lorries Dr. Hire-purchase Interest To Cash being half-yearly instalment under h.p. agreement.	176 0 0 24 0 0	200 0 0
Oct. 1	Motor Lorries Dr. Hire-purchase Interest To Cash being half-yearly instalment under h.p. agreement.	181 5 7 18 14 5	200 0 0

As before, depreciation £150 will be written off on June 30 and accrued interest for three months, £9 7s. 3d., will be provided for.

ENTRIES IN VENDOR'S BOOKS

Goods sold under hire-purchase agreements will always give rise to entries in the books of the seller, whether he finances the transaction himself or passes it over to a hire-purchase finance corporation. In the latter case the amount received from the corporation will usually be less than the normal cash selling price, the difference being in the nature of hire-purchase finance charges. To preserve the ratio of gross profit in the

trader's Trading Account, the full cash price should be carried to Sales Account and the difference between this and the total of (1) the deposit, if any, received from the customer, and (2) the net amount received from the finance corporation, should be written off to Profit and Loss Account as Hire-purchase Finance Charges.

If the trader continues to collect the instalments as agent for the finance corporation, he should use an analysed Cash Book so that the amounts collected for each corporation can be totalled and paid over monthly. The agreement may require the trader to guarantee the collection of the instalments, in which case, if a customer defaults, the trader will have to reimburse the corporation but will have the right, for what it is worth, of recovering the goods. If there is any possibility of future losses arising in this way adequate provision should be made.

Where the trader finances his own agreements, his book-keeping will depend upon whether, in his business, hire-purchase sales are exceptional or constitute the normal medium for effecting sales. If the transactions are comparatively few in number it is usual to treat them as though they were actual sales at the cash price, the interest being spread over the periods to which it relates.

Example

The seller of the two lorries in the example on page 459 could credit Sales Account with £1,000 and debit the purchaser's account with the same amount. Interest is brought into account as it becomes due. The seller balances his books on December 31. The personal account for the customer will be as follows:

A. TRADER—HIRE-PURCHASE ACCOUNT

19—			19—		
Oct. 1	To Goods	1,000 0 0	Oct. 1	By Cash	200 0 0
			Dec. 31	Balance c/d	800 0 0
		£1,000 0 0			£1,000 0 0
Jan. 1	To Balance b/d	800 0 0	Apr. 1	By Cash	200 0 0
Apr. 1	Interest	24 0 0	Oct. 1	,,	200 0 0
Oct. 1	,,	18 14 5	Dec. 31	Balance c/d	442 14 5
		£842 14 5			£842 14 5
Jan. 1	To Balance b/d	£442 14 5			

The balances on this and any similar accounts will be brought into the Balance Sheet as Sundry Debtors under Hire-purchase Agreements and adequate provision must be made for bad debts.

Where hire-purchase agreements are a normal and everyday feature of the business, however, a fundamentally different method is to be preferred. The earning of gross profit is regarded as being conditional upon the due completion of the agreements by customers. Each instalment received is, therefore, regarded as including a proportionate part of the

gross profit and interest on the whole transaction. The outstanding instalments at the date of a Balance Sheet are regarded as stock out on hire-purchase and are valued at cost.

Under this method the personal accounts for the customers, which will probably be in loose-leaf or card-ledger form, are subsidiary to the main system of book-keeping and do not constitute part of the double entry. In the General Ledger an account is opened for Stock out on Hire-purchase, to which will be debited the *cost* (not the cash selling price) of the goods sold by hire-purchase. Instalments collected from customers will be recorded in an analysed Cash Book so that, in addition to being posted in detail to the (memorandum) customer's accounts, they can be credited as monthly totals to the Stock out on Hire-purchase Account.

At the end of the year the outstanding instalments are extracted from the customer's personal accounts, reduced to cost price, and the total is then carried down as a debit balance on the Stock out on Hire-purchase Account, which shows the gross profit realized to date.

Example

STOCK OUT ON HIRE-PURCHASE

		£			£
To Sundries (cost of goods sent out during year under h.p. agreements)		4,000	By Cash (instalments received during year)		2,000
Gross Profit transferred to Profit and Loss Account		500	Balance (outstanding instalments reduced to cost price)	c/d	2,500
		£4,500			£4,500
To Balance	b/d	£2,500			

The method is not theoretically exact as it spreads the interest evenly over the period covered by the agreements, whereas in reality the interest varies in proportion to the outstanding balances. Modifications are possible to meet this and other points. The matter is not of great practical importance, however, as most of the large hire-purchase traders have formed associated companies to finance the agreements.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) What principles are involved in accounting for goods sent out on sale or return, from the point of view of (*a*) the supplier, (*b*) the customer?

(2) Describe a suitable system of accounting for goods sent out on sale or return by a wholesaler where the transactions of this nature are substantial both in value and number.

(3) P & Co., who make up accounts annually to March 31, keep a separate account in their Nominal Ledger to deal with packing materials. Payments are posted direct to the nominal account, no personal accounts being used, and adjustments are made in respect of purchases not yet paid for and stocks on hand at accounting dates.

The following are the particulars of packing materials purchased but not paid for, and stocks on hand respectively on the dates stated:

	Purchases Outstanding	*Stock on Hand*
	£ s. d.	£ s. d.
March 31, 1947	19 5 9	45 12 0
„ 31, 1948	15 12 6	38 15 0
„ 31, 1949	26 3 3	32 8 0

The total of the cash payments made for packing materials during the year to March 31, 1948, was £212 10s. 6d. and during the year to March 31, 1949, £255 1s.

You are required (*a*) to set out the Packing Materials Account for the two years in question, and (*b*) to state what would have been the effect on the net profit in each year if the amount outstanding at March 31, 1948, had been wrongly shown as £5 12s. 6d. (instead of the correct figure of £15 12s. 6d.), all the other figures being correct. (*R.S.A. Stage III*).

(4) What principles are involved in accounting for packages in the books of a supplier, where charges are made to customers for packages and

(*a*) No credit is given for packages returned.

(*b*) Full credit is given for packages returned.

(*c*) Credit is given on return for an amount smaller than that charged?

(5) (*a*) State the essential difference between a hire-purchase agreement and an agreement to pay by instalments.

(*b*) Suggest a system for recording hire-purchase transactions when it is not desired to disclose the cost price of the goods and where an elaborate system involving considerable extra clerical work is not required. (*A.C.C.A. Inter.*).

(6) A road transport company hires lorries on the hire-purchase system over a period of four years. How should the company record these transactions in its books? Illustrate your answer with the journal entries which you consider would be necessary during the first year of the hire-purchase agreement (assuming that instalments are payable half-yearly) and state carefully what records, if any, would appear in the company's Balance Sheet when one year's instalments had been paid.

(7) On January 1 a manufacturer bought an asset on hire-purchase terms. The cash price was £340 and the hire-purchase price £373, payable as to £73 down and the balance in five half-yearly instalments of £60 each.

Set out the material accounts in the manufacturer's ledger for the following three years, assuming that:

(*a*) The books are closed annually on December 31;

(*b*) The hire-purchase charge made by the supplier is on the basis of interest at 8 per cent per annum calculated half-yearly; and

(*c*) The asset is written down at the rate of 20 per cent per annum on the diminishing-balance method.

Figures are to be shown as decimals of a £ to two places.

(*Chartered Accountants, Inter.*).

(8) On April 1, 1947, the Eden Fruit Company, Ltd., took delivery of three delivery vans from Norris Vans, Ltd., on hire-purchase agreement, payment to be made by three equal annual instalments of £300 each, on March 31, 1948, 1949 and 1950. The cash value of the vans on delivery was £817, the vendors charging interest at 5 per cent per annum on the yearly balances. The purchasers wrote off 25 per cent on the diminishing value, as depreciation for each year to March 31. Write up the ledger accounts only, to record the above transactions in the books of (*a*) the Vendor Company, (*b*) the Purchasing Company.

(No journal entries to be made; pence to be ignored in all calculations.)

(*Chartered Accountants, Inter.*).

(9) The total amount payable under a hire-purchase agreement is £630, representing three annual instalments of £200, of which the first was payable on signing the agreement and a final instalment (payable three years after that date) of £30. Interest is known to have been charged at 6 per cent per annum on the outstanding balances. What was the cash price of the articles?

CHAPTER XIX

INCOMPLETE RECORDS: RECEIPTS & PAYMENTS ACCOUNTS

ORGANIZATIONS such as clubs, which do not carry on a business and are not concerned with the earning of profits in the usual sense of that term, may nevertheless be the collective owners of certain funds, including a banking account. These funds are usually under the immediate control of a treasurer, who administers them in accordance with the instructions of a committee. It is desirable that all the members of the organization, and others who may have contributed to its funds, should be given some opportunity of receiving and considering annual accounts.

These annual accounts frequently take the form of a summary of the treasurer's receipts and payments and are then known as a Receipts and Payments Account. In all but the smallest and simplest cases such an account cannot be regarded as ideal, for among other defects it ignores the possible existence of liabilities and of assets other than the cash and bank balances. Nevertheless, it is sometimes to be recommended on the ground of simplicity and is a great advantage where the records are kept by an honorary treasurer who is probably not a skilled accountant. Double-entry book-keeping is not required; the only essential book of account is a Cash Book. Savita

ANALYSED CASH BOOK

As the annual Receipts and Payment Account is a *summary* of the receipts and payments for the year in question, together with the opening and closing cash and bank balances, the Cash Book should be provided with a sufficient number of analysis columns on each side to cover the main headings of income and expenditure. Sundries columns, which will have to be analysed at the end of the year, should be provided for exceptional items.

The number of columns needed will depend upon the nature of the organization, the various ways in which it raises revenue and the principal headings under which it spends money. Suitable headings for a tennis club might be as follows:

Debit (*Receipts*)	*Credit* (*Payments*)
Balance brought forward	Clubhouse Rent
Subscriptions	Clubhouse Repairs and Upkeep
Entrance Fees	Groundsman's Wages
Donations	Upkeep of Courts
Tea Receipts	Tea Payments
Sundries	Printing, Postage and Stationery
TOTAL	Secretary's Honorarium
	Bank Charges
	Sundries
	Balance carried forward
	TOTAL

The balances brought and carried forward must be included in the analysis so that the cross casts agree, but as these items appear only once on each side they could alternatively be entered in the Sundries columns.

The totals are normally carried right through the book for the whole year so that, subject to the Sundries columns being analysed, they give the totals necessary for the annual Receipts and Payments Account.

If a banking account is kept, the Cash Book will record the amounts paid into the bank and cheques drawn respectively. All receipts should be banked and a Petty Cash Account maintained for cash expenditure such as postages. An additional column headed Petty Cash will then be provided on the credit side of the Cash Book in which to enter the cheques drawn from time to time in order to replenish the petty cash. The Petty Cash Book should itself be provided with suitable analysis columns on the credit side so that the bank and cash payments can be amalgamated.

FORM OF ACCOUNTS

A Receipts and Payments Account does not afford much scope for skilful arrangement. The principal aim should be to show the receipts and payments in as much detail as is consistent with the essential simplicity of such an account. Although the opening and closing balances must both be included in order to balance the account, they should preferably be arranged in such a way that they do not enter into the actual totals of receipts and payments for the year. Further, where there are both receipts and payments relating to some specific function or aspect of the organization's work, the one should be deducted from the other so that the net result of this function is shown.

Example

The analysed Cash Book kept by the Hon. Treasurer of the Bareacres Lawn Tennis Club shows the following (bank) receipts and payments for the year ended December 31.

	£	s.	d.		£	s.	d.
Balance, at Bank, Jan. 1	121	6	8	Clubhouse Rent	50	0	0
Members' Subscriptions	250	0	0	Clubhouse Repairs	21	10	0
Entrance Fees	30	0	0	Groundsman's Wages	156	0	0
Donations	63	0	0	Upkeep of Courts	29	9	0
Tea Receipts	96	3	2	Lighting and Heating	20	1	3
Sundries:				Tea Payments	73	10	11
Sale of old mower	10	0	0	Printing and Stationery	16	6	10
Receipts re Xmas Raffle	24	9	6	Secretary's Honorarium	10	10	0
				Petty Cash	80	0	0
				Bank Charges	2	0	0
				Sundries:			
				New mower	40	0	0
				Expenses of Xmas Raffle	10	11	9
				Balance, at Bank, December 31	84	19	7
	£594	19	4		£594	19	4

The treasurer proposes to submit the above to the members, but the

Committee desire to present it in a more intelligible form. For this purpose it is ascertained that the petty cash transactions for the year were as follows:

	£ s. d.		£ s. d.
Balance, Jan. 1	4 6 8	Postage and Stationery	18 2 9
Cash received	80 0 0	Tea Payments	49 10 3
		Upkeep of Courts	8 6 8
		Balance, Dec. 31	8 7 0
	£84 6 8		£84 6 8

The petty cash transactions should be incorporated in the main account, which is improved by being set out as below.

THE BAREACRES LAWN TENNIS CLUB

Receipts and Payments Account for the year ended December 31

Receipts			*Payments*		
Members' Subscriptions		250 0 0	Groundsman's Wages		156 0 0
Entrance Fees		30 0 0	Upkeep of Courts		37 15 8
Donations		63 0 0	Clubhouse Rent		50 0 0
Profit from Xmas Raffle:			Clubhouse Repairs		21 10 0
Receipts	24 9 6		Lighting and Heating		20 1 3
Expenses	10 11 9		Loss on Club Teas:		
		13 17 9	Payments	123 1 2	
		356 17 9	Receipts	96 3 2	
					26 18 0
Balance at January 1:			Printing, Stationery and Postage		34 9 7
In Hand	4 6 8		Secretary's Honorarium		10 10 0
At Bank	121 6 8		Bank Charges		2 0 0
		125 13 4	Replacement of Mower:		
			Cost of new machine	40 0 0	
			Proceeds of sale of old machine	10 0 0	
					30 0 0
					389 4 6
			Balances at December 31:		
			In Hand	8 7 0	
			At Bank	84 19 7	
					93 6 7
		£482 11 1			£482 11 1

LIMITATIONS OF RECEIPTS AND PAYMENTS ACCOUNTS

However much attention is paid to the setting out of a Receipts and Paymesnt Account, it can rarely give a full picture of the financial condition of the undertaking which issues it.

An account of receipts is not necessarily a complete statement of *income*, for some items which can properly be regarded as income of one period may not be received until the next. Conversely, certain items of *expenditure* may be outstanding at any given date and an account of payments is, therefore, not necessarily a true reflection of expenditure. Such omissions have a two-fold effect, for in addition to being omitted from the account for the period to which they relate, they come into the account for the subsequent period, to which they do not relate.

Income due in one period but not received until the next is an asset which, in a more complete system of accounting, would be revealed in the Balance Sheet prepared as on that date. There may be other assets

the existence of which is not revealed, or is only partially revealed, by an annual Receipts and Payments Account. Where stocks are carried (for example, a club with a licensed bar) a Receipts and Payments Account is deficient also in the following respects:

(1) It will show the amount paid to suppliers during the period, which is not a true reflection of the cost of the supplies actually purchased.

(2) As no adjustment is made for the opening and closing stocks it is even less a reflection of the cost of the supplies actually sold to members.

(3) As there will normally be no credit sales, the whole of the proceeds of sale are nevertheless included in the receipts.

Fixed assets such as land, clubhouse premises and equipment may be owned, but a Receipts and Payments Account will entirely conceal this fact unless there has been an actual purchase or sale of such fixed assets during the year. The Profit and Loss Account of a trading concern would normally make some provision for depreciation of fixed assets; a Receipts and Payments Account can never record depreciation except by way of cost of renewal.

If investments are owned their existence may be revealed indirectly because the interest from them will be recorded as a receipt; a Balance Sheet would show the position much more clearly and would include investments which have not produced any dividend. Similarly, if there are loans on which interest is payable, the Receipts and Payments Account can give only indirect recognition to this fact by recording the interest paid during the year, which might not in all cases be the full amount payable.

It is clear, therefore, that except in the smallest and simplest cases a Receipts and Payments Account can never be a fully satisfactory form of annual account. In other cases it may in fact prove misleading, unless it is read with a full appreciation of its limitations. For example, it might disclose an excess of receipts over payments, due to delay in paying several items of expenditure, whereas the expenditure incurred may have substantially exceeded the income earned.

INCOME AND EXPENDITURE ACCOUNTS

An account which is not restricted to receipts and payments but shows the actual income and expenditure appropriate to a given period is known as an Income and Expenditure Account. It is the equivalent, for a non-trading concern, of a trader's Profit and Loss Account. Where it is prepared, as it normally should be, from a proper set of double-entry books it is, like a Profit and Loss Account, part of the process of closing the books at the end of the year. The remaining balances representing assets, liabilities and accumulated surplus (if any) are then presented in a Balance Sheet.

An Income and Expenditure Account reflects the revenue, as distinct from the capital, transactions of a given period—usually one year. The capital transactions are, of course, recorded in the Balance Sheet. Both documents are necessary to obtain a true picture of the financial results

of the organization by which they are issued; together they constitute its annual accounts. The Income and Expenditure Account may also be regarded as a link between successive Balance Sheets.

The balance disclosed by an Income and Expenditure Account is referred to as Excess of Income over Expenditure or Excess of Expenditure over Income as the case may be, these expressions being the equivalent of the net profit or net loss disclosed by a Profit and Loss Account. This balance is usually transferred to an Accumulated Fund Account, which is sometimes called the Accumulated Balance on Income and Expenditure Account. In this way a distinction is drawn between (1) the excess or deficiency of income for the year under review, and (2) the net accumulated excess for all years since operations started.

The Accumulated Fund is similar in many respects to the Profit and Loss Appropriation Account of a limited company, but as there is no share capital it will not be reduced by the payment of dividends to members. It also represents capital accumulated out of revenue.

Capital may also be provided in the form of loans from members and others. These loans will, of course, appear in the Balance Sheet as liabilities. Interest payable on such loans, including accrued interest that has not actually been paid at the date of the Balance Sheet, should be charged in the annual Income and Expenditure Account.

BOOKS OF ACCOUNT

The minimum requirements for a non-trading concern that wishes to publish annual Income and Expenditure Accounts and Balance Sheets are a Cash Book and General Ledger. Where a separate petty cash is kept a Petty Cash Book will also be required. If subscriptions are payable by members a Subscription Register or other record of subscriptions due and received will be necessary, but this is not, as a rule, made part of the double-entry system.

If there are substantial purchases of goods (for instance, in the case of a club with a licensed bar and restaurant facilities) it may be desirable to keep a Purchases Journal and Bought Ledger. A Sales Ledger in the ordinary sense will not be required, but a residential club, or hostel or similar undertaking, might make use of a Tabular Ledger, as on the following page.

The Cash Book should be provided with suitable analysis columns on each side so that many of the cash postings can be made in total. If a Bought Ledger is kept, one of the credit columns will be used to record payments to suppliers. The total of this column can then be debited to Bought Ledger Control Account in the General Ledger, so that the Bought Ledger is separately balanced and the General Ledger is self-contained.

Similarly, subscriptions will be posted in total to the credit of Subscriptions Account in the General Ledger, whatever arrangements may be made for recording them elsewhere in detail.

The Trial Balance of the General Ledger, including the Cash Book and Petty Cash Book, will reveal the balance on the General Ledger

after all the Cash Book and (where applicable) Petty Cash Book and Purchases Journal postings have been made. Before the Income and Expenditure Account can be prepared, however, it will be necessary to make many adjustments for outstanding expenses and the like. These, except for some special points arising from the treatment of such items as subscriptions, follow the lines of those discussed in Chapter VII in relation to a trader's accounts.

TABULAR LEDGER FOR HOSTEL OR RESIDENTIAL CLUB

Week Ended						
Name						
Room No.						
Full Board						
Room only						
Breakfast						
Luncheon						
Tea						
Dinner						
Laundry						
etc.						
etc.						
Paid Out						
Total for week						
Balance b/f						
Cash received						
Discount or Allce.						
Balance c/f						

Subscriptions are normally payable once a year, in advance. They may be the same for all members or they may differ according to the various classes of membership. Reminders will normally have to be sent out to members when the subscriptions become due and will have to be followed up at later dates in the case of those who delay payment. The records of membership should be arranged in such a way as to facilitate the prompt collection of subscriptions.

In a small club or similar undertaking where all members pay the same rate of subscription, a columnar register containing a record covering several years at each opening may be suitable. The following ruling is suggested:

SUBSCRIPTION REGISTER

Member's Name	*Member's Address*	1947		1948		1949		
		Date	*Amount*	*Date*	*Amount*	*Date*	*Amount*	*etc.*
			£ s. d.		£ s. d.		£ s. d.	
Simkins, P.		2.3.47	2 2 0					
Sampson, A.		1.4.47	2 2 0	8. 1.48	2 2 0			
Sully, M.		10.1.47	2 2 0	5. 1.48	2 2 0			
Smith, H.		3.1.47	2 2 0	29.12.47	2 2 0			
etc.				etc.				

As an alternative, or in addition to, the date of payment, the receipt number could be shown. Official receipts should be issued by the treasurer for all subscriptions paid.

In larger concerns, and particularly those in which there are different grades of membership, such as professional associations, some type of card ledger will be desirable. The amount of information to be recorded on each card, apart from the actual record of subscriptions paid, will depend on the nature of the organization. The following might be a suitable ruling:

Name	Class of Membership
	Date Admitted
Address	Sponsors
	Changes in Membership
Tel. No.	

Year ended	*Subscription*			*Notices*			*Date of Payment*	*Receipt No.*	*Remarks*
				1	2	3			

(*The subscription record continues on the back.*)

The columns headed "Notices 1, 2, 3" record the sending out of the original application for the member's subscriptions and two subsequent reminders if it is not paid promptly. Coloured tabs which clip on to the top edge of the card can also be used to indicate class of membership, overdue subscriptions, and so on.

As subscriptions are normally payable in advance, the number that will remain unpaid at the end of each year should be comparatively small. The very fact that a subscription is a year overdue is an indication that its recovery is doubtful. To the extent that such arrears have actually been received before the accounts are completed they may be brought into account as an asset; otherwise they are usually ignored. This does not mean that steps will not be taken to recover them, but if they are eventually received they will be brought into the Income and Expenditure Account for the year of receipt.

On the other hand, it is possible that some subscriptions which relate to the following year may be received before the end of the current year. Such subscriptions should not be regarded as current income but should be carried down as a credit balance on Subscriptions Account (so that next year's Income and Expenditure Account will receive credit for them) and shown on the liabilities side of the Balance Sheet as Subscriptions Received in Advance.

ENTRANCE FEES

Entrance fees cannot normally be regarded as ordinary annual income; on the other hand, the receipt of an entrance fee does not create any special liability to the member concerned—he is entitled to the same benefits of membership as are the existing members who pay only their annual subscriptions.

If taken to credit of Income and Expenditure Account, entrance fees should always be shown as a separate item. An alternative, which is particularly to be recommended in the early years of a new concern when receipts from this source will be disproportionately high, is to carry them to the credit of Accumulated Fund Account.

LIFE MEMBERS

If members are offered life membership in return for a lump sum payment, which frees them from the obligation of paying future annual subscriptions, a separate Life Members Account should be opened in the ledger, to which such lump sums are credited. It would clearly be wrong to take credit for the whole of this amount as revenue in the year in which it is received. The following alternatives are available:

(1) To carry forward the full amount received from each life member until he dies, when it will be transferred to the credit of Accumulated Fund.

(2) To transfer to the credit of Income and Expenditure Account annually an amount equivalent to the normal annual subscription. If a life member dies before the whole of his subscription has been transferred in this way, the balance will then be transferred to Accumulated Fund Account.

(3) To transfer to the credit of Income and Expenditure Account annually a proportion of the life subscription calculated by reference to the age and expectation of life of each member. This method is too complicated to be of general use.

SPECIAL FUNDS

Where accounts or funds are created for special purposes they should be recorded separately in the ledger. Income and expenditure relating to them should also be recorded separately (as far as possible) and not merged in the general Income and Expenditure Account.

The word fund should, strictly, be used only where the amounts received for the special purpose are separately invested. In other circumstances the word account is more appropriate; Life Members Account is a case in point.

ANNUAL ACCOUNTS

In addition to the special points considered in the preceding paragraphs, the annual Income and Expenditure Account and its accompanying Balance Sheet should be set out in a way that will convey the maximum of information to the members. Items of income and expenditure which relate to one particular aspect of the association's activities should be grouped so as to show the net financial result of that activity. This principle may sometimes be carried to the length of preparing a complete account (for example, Bar Trading Account) which is subsidiary to the main Income and Expenditure Account.

In the Balance Sheet, the usual distinctions between fixed and floating assets, current and long-term liabilities, should be maintained. If investments are carried in the books at cost the market value at the date of the Balance Sheet should also be shown by way of note. Special funds which are separately invested can conveniently be shown in the bottom half of the Balance Sheet, in which sub-totals separate such funds from the general assets and liabilities.

Example

The following is the Trial Balance of the books of a Professional Society as at December 31.

	£	£
Accumulated Fund		103,808
Freehold Hall and Offices	80,000	
Investments at cost	28,305	
,, Depreciation account		2,140
Interest on Investments accrued, due December 31	72	
Sundry Debtors and Creditors	155	3,819
Entrance Fees		4,620
Certificate Fees and Subscriptions		11,714
Examination Fees		2,856
Subscriptions received in advance		200
Carried forward	£108,532	£129,157

Trial Balance (*continued*)

		£	£
	Brought forward	108,532	129,157
Interest from Investments			932
Hire of Rooms			282
Sundry Fines and Fees			416
Prize Trust Funds			5,120
,, ,, Investments		5,120	
,, ,, Prizes awarded		400	
,, ,, Income			420
,, ,, Balance at Bank on Income Account		20	
Expenses of Management		11,742	
Rates, Taxes, etc.		1,976	
Expenses of Examinations		3,218	
Allowances to other Societies, etc.		826	
Balance at Bank		875	
Cash in Hand		78	
Furniture and Fittings		2,100	
,, ,, ,, Additions		240	
Library		1,051	
,, Additions		149	
		£136,327	£136,327

The following liabilities are not included in the above figures:

Expenses of Management	£250
Rates, Taxes, etc.	£100

You are required to prepare an Income and Expenditure Account for the year ended December 31 and a Balance Sheet as at that date. Provide for depreciation of furniture £210 and depreciation of library £105. Entrance Fees to be treated as Income.

(*Chartered Accountants, Inter.*).

THE ———— SOCIETY

Income and Expenditure Account for the year ended December 31

	£	£	£		£
To Expenses of Management		11,992		By Certificate Fees and Subscriptions	11,714
Rates, Taxes, etc.		2,076		Entrance Fees	4,620
Depreciation:				Interest from Investments	932
Furniture	210			Hire of Rooms	282
Library	105			Sundry Fines and Fees	416
		315			
			14,383		
Allowances to other Societies			826		
Examination Expenses		3,218			
Less Examination Fees		2,856			
			362		
			15,571		
Excess of Income over Expenditure, carried to Accumulated Fund			2,393		
			£17,964		£17,964

Balance Sheet as at December 31

		£	£
Accumulated Fund:			
Balance brought forward at January 1		103,808	
Add Excess of Income over Expenditure for the year ended December 31		2,393	
			106,201
Current Liabilities and Provisions:			
Sundry Creditors		4,169	
Subscriptions received in advance		200	
			4,369
			110,570
Prize Trust Funds:			
Capital		5,120	
Income	£420		
Less Prizes awarded	400	20	
			5,140
			£115,710

	£	£
Freehold Hall and Offices, at cost		80,000
Furniture and Fittings, at cost, less depreciation	2,100	
Additions during year, at cost	240	
	2,340	
Less Depreciation	210	
		2,130
Library, at cost, less depreciation	1,051	
Additions during year, at cost	149	
	1,200	
Less Depreciation	105	
		1,095
		83,225
Investments, at cost	28,305	
Less Reserve for depreciation	2,140	
		26,165
(*If the current market value is other than £26,165 it should be noted here.*)		
Sundry Debtors		155
Interest accrued due on Investments		72
Balance at Bank		875
Cash in Hand		78
		110,570
Prize Trust Funds Investments	5,120	
Cash at Bank on Income Account	20	
		5,140
		£115,710

CONVERSION OF RECEIPTS AND PAYMENTS TO INCOME AND EXPENDITURE ACCOUNT

Although it is always desirable that a complete set of books (that is, a ledger at least, in addition to the Cash Book) should be kept, in which case the annual accounts will be prepared from the Trial Balance of the books, it is not always possible to achieve this ideal in practice. It may be assumed, however, that there will always be a record of cash transactions from which a Receipts and Payments Account can be drawn up. An Income and Expenditure Account can then be prepared by making appropriate adjustments for outstanding items of income and expenditure at the beginning and end of the year. If information is available as to the other assets and liabilities, a Balance Sheet can also be prepared. The following example illustrates the method:

Example

The Blanktown Golf Club prepares accounts annually to March 31. The clubhouse and ground had been acquired on a lease expiring on March 31, 1998, and in order to finance the laying out of the course, etc., loans of £100 each free of interest had been received from persons who, in consideration of such loans, became life members of the club.

These loans were repayable at any time at the option of the club and on March 31, 1948, loans from 66 life members were outstanding.

The expenditure on laying out the course and altering the clubhouse was capitalized under the heading of Development Account and this was being written off year by year in proportion to the unexpired period of the lease. As on March 31, 1948, the amount standing at the debit of Development Account was £4,950.

The dining room and bar are run by a firm of professional caterers, who pay the club by way of rent 5 per cent of the gross takings.

On March 31, 1948, the club's assets, other than cash and expenditure on development, were as follows:

	£	s.	d.
Furniture and Fittings, valued at	1,550	0	0
Machinery and Tools, valued at	572	10	0
Sundry Materials (for upkeep of the course), valued at	37	0	0
Stamps and Stationery, valued at	17	15	0
£1,200 3½ per cent War Loan, at cost	1,226	10	6
One quarter's rent due from caterers	41	12	9

On the same date £250 was owing for one quarter's rent under the lease and £12 15s. 10d. for telephone. Membership subscriptions had been received in advance for 1948/49 amounting to £94 10s.

The following is a summary of the club's Cash Book for 1948/49:

	£	s.	d.		£	s.	d.
Balance, March 31, 1948	406	16	7	Rent to December 31, 1948	1,000	0	0
Entrance Fees	48	6	0	Rates to March 31, 1949	372	10	0
Subscriptions 1948/49	3,602	11	0	Salary of Professional	500	0	0
,, 1949/50	90	6	0	Salary of Secretary	375	0	0
Green Fees	312	8	0	Heating and Lighting	171	15	0
Locker Fees	71	10	0	Upkeep of Course:			
Rent from Caterers	158	3	2	Wages	631	10	0
Interest on War Loan:				Materials	215	7	6
June 1, 1948	21	0	0	House Wages	215	17	6
December 1, 1948	24	10	0	House Cleaning and Sundries	85	13	8
				Postage, Stationery and Telephone	99	15	5
				Purchase of Motor Mower	170	0	0
				Purchase of £200 3½ per cent War Loan	206	12	0
				Life Members' Loans repaid	300	0	0
				Balance, March 31, 1949	391	9	8
	£4,735	10	9		£4,735	10	9

You are required to draw up the club's Income and Expenditure Account for the year to March 31, 1949, and Balance Sheet as on that date, taking into account the following adjustments:

(1) Sundry Materials (for upkeep of the course) were valued at £63 10s. and unused stamps and stationery at £13 5s.

(2) £50 is to be provided for depreciation of machinery and tools and £75 for depreciation of furniture and fittings.

(3) Provision is to be made for £250 for one quarter's rent and £14 5s. 8d. for telephone.

(4) £38 6s. 3d. is due from the caterers for a quarter's rent.

(5) The appropriate amount is to be written off Development Account.

(*Chartered Accountants, Inter.*).

The completed accounts are shown on page 479; the method of working is as follows:

(1) The opening balance on Accumulated Fund is computed from the information given in regard to assets and liabilities on April 1, 1948, namely:

	£ s. d.	£ s. d.
Development Account		4,950 0 0
Cash at Bank, per Cash Book Summary		406 16 7
Other assets, as listed		3,445 8 3
		8,802 4 10
Less Liabilities, etc.		
Rent	250 0 0	
Telephone	12 15 10	
Subscriptions in advance	94 10 0	
		357 5 10
		8,444 19 0
Less Loans from Life Members 66 at £100		6,600 0 0
		£1,844 19 0

(2) The amount to be written off Development Account is calculated as follows:

Unexpired term of lease from April 1, 1948 to March 31, 1948 = 50 years.
Amount to be written off = $\frac{1}{50}$th of £4,950 = £99.

(3) Payments of expenses such as rent are adjusted by:

(*a*) Deducting from them the amount known to relate to the previous year, as shown in the opening liabilities.

(*b*) Adding to them the amount stated to be owing at the end of the year.

(*c*) Making reverse adjustments for unexpired expenditure (such as stationery and postage stamps) carried forward as an asset.

Example

	£	s.	d.
Postage, Stationery and Telephone: Amount paid during year	99	15	5
Less Telephone for previous year included in above	12	15	10
	86	19	7
Add Telephone for current year not yet paid	14	5	8
	101	5	3
Add Stamps and Stationery brought forward at beginning of year	17	15	0
	119	0	3
Less Stamps and Stationery carried forward	13	5	0
	£105	15	3

(4) The Income and Expenditure Account is then built up from the (adjusted) receipts and payments which are of a revenue nature plus the amounts to be written off fixed assets.

(5) The Balance Sheet is finally prepared; it incorporates

(*a*) The fixed assets shown in the opening statement, less the amounts written off for depreciation.

(*b*) Any new assets (such as the purchase of an additional holding of War Loan) revealed by the Receipts and Payments Account.

(*c*) The Life Members Loans Accounts as shown in the opening statement, less the loans repaid during the year.

(*d*) The closing adjustments for outstanding expenses, subscriptions received in advance, etc., already taken into account in converting the receipts and payments to income and expenditure.

(*e*) The closing cash balance as shown by the Cash Book summary.

THE BLANKTOWN GOLF CLUB

Income and Expenditure Account for the year ended March 31, 1949

	£	s.	d.	£	s.	d.
To Rent	1,000	0	0			
Rates	372	10	0			
Amount written off Development A/c	99	0	0			
				1,471	10	0
Upkeep of Course:						
Wages	631	10	0			
Materials	188	17	6			
	820	7	6			
Salary of Professional	500	0	0			
Depreciation of Machinery and Tools	50	0	0			
				1,370	7	6
House Wages	215	17	6			
Heating and Lighting	171	15	0			
House Cleaning and Sundries	85	13	8			
Depreciation of Furniture and Fittings	75	0	0			
				548	6	2
Salary of Secretary	375	0	0			
Postage, Stationery and Telephone	105	15	3			
				480	15	3
				3,870	18	11
Excess of Income over Expenditure, carried to Accumulated Fund				458	12	9
				£4,329	11	8

	£	s.	d.
By Subscriptions	3,697	1	0
Entrance Fees	48	6	0
Green Fees	312	8	0
Locker Rents	71	10	0
Rent from Caterers	154	16	8
Interest on War Loan	45	10	0
	£4,329	11	8

Balance Sheet as at March 31, 1949

	£	s.	d.	£	s.	d.
Accumulated Fund:						
Balance brought forward at April 1, 1948	1,844	19	0			
Add Excess of Income over Expenditure for the year ended March 31, 1949	458	12	9			
				2,303	11	9
Loans from Life Members:						
Balance outstanding at April 1, 1948	6,600	0	0			
Less Repaid during year	300	0	0			
				6,300	0	0
Current Liabilities and Provisions:						
Sundry Creditors	264	5	8			
Subscriptions received in advance	90	6	0			
				354	11	8
				£8,958	3	5

	£	s.	d.	£	s.	d.
Development Account:						
Balance brought forward at April 1, 1948	4,950	0	0			
Less Amount written off	99	0	0			
				4,851	0	0
Furniture and Fittings:						
As valued at April 1, 1948	1,550	0	0			
Less Depreciation, written off	75	0	0			
				1,475	0	0
Machinery and Tools:						
As valued at April 1, 1948	572	10	0			
Motor Mower, purchased, at cost	170	0	0			
	742	10	0			
Less Depreciation, written off	50	0	0			
				692	10	0
				7,018	10	0
Stock of Materials for upkeep of Course	63	10	0			
Stationery and Postage Stamps	13	5	0			
Rent due from Caterers	38	6	3			
Investment, at cost, £1,400 3½ per cent War Loan	1,433	2	6			
Cash at Bank	391	9	8			
				1,939	13	5
				£8,958	3	5

PREPARATION OF ACCOUNTS FROM INCOMPLETE RECORDS

The conversion of a summary of receipts and payments into a proper Income and Expenditure Account with its attendant Balance Sheet is only one example of the more general problem of preparing annual accounts from incomplete records. Where a complete set of books is kept by double-entry this problem does not arise; in practice, however, many traders have neither the time nor the knowledge of book-keeping to keep such books.

Annual accounts of some sort, showing the net trading profit for the year, are nearly always required for one reason or another. Assessments to income tax and other taxes based on profits are dependent on the submission of such accounts to the appropriate authorities; a trader who cannot submit accurate accounts for this purpose is likely to find himself confronted with estimated assessments which he cannot rebut.

Anything short of a full set of double-entry books may be regarded as an incomplete record. There are, however, several degrees of incompleteness. If there is an accurate account of all receipts and payments (including cash as well as bank transactions), coupled with an annual stock-taking and records (not necessarily books of account) from which assets and liabilities at the Balance Sheet date can be ascertained, then fair accuracy in the final accounts can be secured.

On the other hand, where these minimum requirements are not fulfilled, or where the records, which would otherwise have been adequate, have been destroyed, some degree of estimation becomes essential. The accuracy of the accounts will then be dependent on the correctness of these estimates.

CASH RECORDS

A complete summary of all receipts and payments is the first essential if a detailed and accurate Trading and Profit and Loss Account is required. A trader who is unable or unwilling to keep a full set of books should, therefore, use a Cash Book which will facilitate the preparation of an annual summary. If all receipts are banked and all payments, other than petty cash items, are made by cheque, the ruling will be simplified, but an adequate number of analysis columns should be provided.

CAS

Date	Receipts	Takings	Other Receipts	Total (Bank)	Date	P

* *If space permits, separate columns should be pro*
(1) Rent and Rates; (2) Lighting and Heatin
(5) Advertising, according to the nature of th

A suitable ruling is shown below. On the debit side there will be comparatively few items paid into the bank which do not represent cash sales or receipts from credit customers; all such exceptional receipts (for example, sale of plant or fixed assets, additional capital paid in by the trader, and income tax refunds) are recorded in the Other Receipts column, which is analysed at the end of the year. On the credit side, however, columns are required, as a minimum, for:

(1) All payments to suppliers of goods for re-sale (that is, Purchases or Stock).

(2) Expenses in sufficient detail to make further analysis unnecessary, including one for General Expenses.

(3) Proprietor's drawings.

(4) Cheques drawn for petty cash, the expenditure of which will be recorded in a Petty Cash Book.

(5) Payment for plant, fixtures and other fixed assets.

(6) A Sundries column for exceptional items which do not fit into any of the foregoing. This column, like the Other Receipts column, will have to be analysed at the end of the year.

It is advisable to total and cross-cast the book at the end of each month, the bank balance being reconciled with that shown by the bank statement and carried forward to the next month. The twelve monthly sets of totals can then be summarized at the end of the book.

If the takings are not banked intact but are used partly for such purposes as payment of wages and cash expenses and for the proprietor's personal expenses and drawings, some modification is necessary. One system is to have separate books for cash and bank transactions respectively, the ruling of each being similar to that illustrated below, with one additional column in each book, namely:

(1) In the Bank Book, an additional column on the *debit* side for cash banked.

(2) In the Cash Book, an additional column on the *credit* side for cash banked.

If all takings, including cheques received from customers, are first

BOOK

…ents	*Total (Bank)*	*Purchases*	*Drawings*	*Petty Cash*	*Wages*	* *Expenses*	*Sundries*

…ided for the main items of expenditure, such as …3) Postage, Stationery and Telephone; (4) *Insurance; …usiness carried on;* (6) *Fixed Assets.*

entered in the Cash Book, a Takings column in the Bank Book will be unnecessary and the Cash Banked column can take its place. This will enable similarly ruled books with three debit cash columns and about twelve (or more, according to the degree of analysis of expenses required) credit columns to be used for each purpose.

Alternatively, a combined Cash and Bank Book can be used. This can be similar to the three-column Cash Book shown on pages 52 and 53 in connexion with double-entry book-keeping, with the addition of analysis columns. An additional analysis column on each side for Cash Banked will have to be provided, to enable the monthly cross-cast of the analyses to be agreed.

COMBINED CASH

Date	*Description*	*Takings*	*Other Receipts*	*Cheques Drawn*	*Total*	*Date*	*Description*
19—						19—	
Jan. 1	Balance b/f		20 6 10		20 6 10	Jan. 2	Cash purchases
1	Takings	10 6 3			10 6 3		Rent
2	,,	19 9 11			19 9 11	3	Bank
				50 0 0	50 0 0		Electricity
3	,,	17 2 8			17 2 8	4	Wages
				6 10 0	6 10 0		Drawings
4	,,	31 2 9			31 2 9		Income Tax
				63 9 0	63 9 0		Sch. "D"
	Capital A/c						Bank
	Legacy		100 0 0		100 0 0	6	Stationery
6	Takings	8 3 1			8 3 1		Electric Fittings
				58 10 0	58 10 0		Bank
7	,,	12 1 7			12 1 7		X Machine Co.
	Sale of old						Scales
	Scales		5 0 0		5 0 0		Adder & Co.
10				75 7 8	75 7 8		Accountancy
							Charges
						7	Cash purchases
						10	JM & Co.
							AB, Ltd.
							X Bros.
							etc.
						31	Balance c/f
		£98 6 3	£125 6 10	£253 16 8	£477 9 9		

Note. This combined Cash and Bank Book is designed primarily to record receipts and payments of cash and to show the balance of cash in hand. Payments into and out of the bank are necessarily recorded, as they affect the balance of cash in hand, but the bank balances are not recorded. Provided the opening bank balance is known, however, the closing balance can be calculated quite easily as follows:

In the hands of the inexperienced such a book is apt to prove difficult. The ruling shown below is sometimes encountered. In this book all receipts and all payments are recorded in the main and analysis columns, whether they be cash or bank transactions. The function of the main columns is to show the cash balance, as distinct from the bank balance. Amounts paid into the bank are, therefore, recorded as payments only, while all cheques drawn (and, therefore, already recorded as payments) are entered also on the debit (receipts) side.

The method is illustrated by the specimen entries that have been made; these are also shown in the alternative (and preferable) form of separate cash and bank books on the following two pages.

AND BANK BOOK

Total	*Cash Banked*	*Payments for Goods Purchased*	*Rent and Rates*	*Wages*	*Lighting and Heating*	*Postage and Stationery*	*Drawings*	*Sundries*
6 0 0		6 0 0						
50 0 0			50 0 0					
30 0 0	30 0 0							
6 10 0					6 10 0			
15 0 0				15 0 0				
7 0 0							7 0 0	
63 9 0							63 9 0	
100 0 0	100 0 0							
15 0						15 0		
2 0 0								2 0 0
30 0 0	30 0 0							
48 0 0								48 0 0
10 10 0								10 10 0
4 10 0		4 10 0						
39 3 1		39 3 1						
26 2 8		26 2 8						
10 1 11		10 1 11						
28 8 1								28 8 1
£477 9 9	£160 0 0	£85 17 8	£50 0 0	£15 0 0	£6 10 0	15 0	£70 9 0	£88 18 1

		£	s.	d.
Bank balance on Jan. 1, 19—	(say)	293	2	8
Add Cash banked		160	0	0
		453	2	8
Less Cheques drawn		253	16	8
Closing Bank balance		£199	6	0

RECEIPTS AND PAYMENTS

Date	Description	Takings	Other Receipts	Total	Date	Description
19—						
Jan. 1	Balance b/f		20 6 10	20 6 10	Jan. 2	Cash purchases
1	Takings	10 6 3		10 6 3	3	Bank
2	”	19 9 11		19 9 11	4	Wages
3	”	17 2 8		17 2 8		Drawings
4	”	31 2 9		31 2 9	6	Stationery
6	”	8 3 1		8 3 1		Electric fittings
7	”	12 1 7		12 1 7		Bank
	Sale of old scales		5 0 0	5 0 0	7	Cash purchases
						etc.
					31	Balance c/f
		£98 6 3	£25 6 10	£123 13 1		

RECEIPTS AND PAYMENTS

Date	Description	Cash Banked	Other Receipts	Total	Date	Description
19—						
Jan. 1	Balance b/f		293 2 8	293 2 8	Jan. 2	Rent
3	Cash	30 0 0		30 0 0	3	Electricity
4	Capital A/c (Legacy paid into Bank)		100 0 0	100 0 0	4	Income Tax, Sch. “D”
					6	X Machine Co., Scales
6	Cash	30 0 0		30 0 0		Adder & Co. Accountancy Charges
					10	J M & Co.
						A B Ltd.
						X Bros.
						etc.
					31	Balance c/f
		£60 0 0	£393 2 8	£453 2 8		

(CASH) BOOK

Total	*Cash Banked*	*Payment for Goods*	*Drawings*	*Wages*	*Postage and Stationery*	*Sundries*
6 0 0		6 0 0				
30 0 0	30 0 0					
15 0 0				15 0 0		
7 0 0			7 0 0			
15 0					15 0	
2 0 0						2 0 0
30 0 0	30 0 0					
4 10 0		4 10 0				
28 8 1						28 8 1
£123 13 1	£60 0 0	£10 10 0	£7 0 0	£15 0 0	15 0	£30 8 1

(BANK) BOOK

Total	*Payment for Goods*	*Rent and Rates*	*Lighting and Heating*	*Drawings*	*Plant and Equipment*	*Sundries*
50 0 0		50 0 0				
6 10 0			6 10 0			
63 9 0				63 9 0		
48 0 0					48 0 0	
10 10 0						10 10 0
39 3 1	39 3 1					
26 2 8	26 2 8					
10 1 11	10 1 11					
199 6 0						199 6 0
£453 2 8	£75 7 8	£50 0 0	£6 10 0	£63 9 0	£48 0 0	£209 16 0

DEBTORS AND CREDITORS

A trader who regularly allows credit to his own customers will be obliged to keep some record in the nature of a Sales Ledger to enable him to collect the outstanding accounts as they become due. If a ledger is used it will probably be kept by single entry, that is, the debits for goods sold to customers will be made directly into their accounts and not posted from a Day Book. Alternatively, the records may be in Day Book form and not posted to a ledger, in which case the entries will be marked off in the book as soon as they are received. The marking off should indicate the date of payment; a date stamp can conveniently be used for this purpose. A schedule of sundry debtors can then be extracted at any time.

A Bought Ledger is not essential if invoices received from suppliers are filed methodically and checked against the monthly statements before the latter are paid. Examination of the file of monthly statements will enable a schedule of sundry creditors to be taken out. If this work is done soon after the Balance Sheet date the unpaid statements (which will probably be on a different file) must not be overlooked; there may also be some invoices for which statements have not yet been received.

The main schedule of sundry creditors should be restricted to creditors for goods purchased. Other liabilities, for outstanding expenses and the like, should be listed separately.

DISCOUNTS

Cash discounts are usually ignored unless Personal Ledgers are kept, when they may be noted against the relative cash items. As there is no double entry to be completed it is not necessary to record the discounts in the Cash Book. One result of this omission is that purchases and sales are shown "net" in the Trading Account (that is, cash discounts are treated in the same way as trade discounts and regarded as a reduction in the purchase and sale prices respectively, theoretical exactitude thus being overruled by practical necessity).

FIXED ASSETS

Fixed assets acquired during the year will be reflected in the summary of payments unless they have not yet been paid for, in which case the outstanding liability must be noted. Except in the first year of a new business, however, most of the fixed assets will have been in existence throughout the year. Where the trader is endeavouring to prepare accounts for the first time he will have to make, or to have made, an inventory of his assets, valuing them as nearly as possible at original cost less depreciation. This valuation will enable a Balance Sheet to be prepared for the first time; in subsequent years the opening figures will be picked up from the previous Balance Sheet, additions made during the year will be added and a reasonable provision for depreciation should then be deducted. The fact that double-entry books are not kept should not prevent the application of proper principles of accountancy in regard to depreciation of assets and other matters which are merely reflections of the distinction between capital and revenue.

Even though double-entry books have not been kept it is still possible to apply the *principles* of double-entry when preparing the annual accounts. A methodical approach to the problem will enable the desired result to be achieved more easily and quickly than would otherwise be the case. The method recommended involves the building up on paper (in the absence of a ledger) of accounts which reflect in total transactions, assets, and so on, which would be recorded in detail in the ledgers of a proper double-entry system.

In the first place, the Cash Book must be analysed and summarized so that an account of receipts and payments can be set out in ledger form. Cash and bank items respectively should be set out in adjacent columns so that totals under each heading can be computed. The result might appear as follows:

S. E. TRADER

Summary of Receipts and Payments for year ended March 31

	Cash	*Bank*	*Total*		*Cash*	*Bank*	*Total*
	£	£	£		£	£	£
Balances b/f	25	310	✓ 335	Suppliers	50	7,891	✓ 7,941
Takings	10,208		✓ 10,208	Wages and Salaries	750	400	1,150
Legacy		200	200	Drawings	630		✓ 630
Sale of Van, Sept. 30		40	✓ 40	Rent and Rates		270	✓ 270
Interest on Investment		50	50	Insurance		15	✓ 15
Rent receivable	50		✓ 50	Bank Charges		6	6
Cash banked		8,766	¢ 8,766	New Van, Sept. 30		400	✓ 400
Bank overdraft c/f		379	379	Investment		500	500
				Sundry Expenses	69	203	272
				Income Tax		60	✓ 60
				Cash banked	8,766		¢ 8,766
				Balance c/f	18		18
	£10,283	£9,745	£20,028		£10,283	£9,745	£20,028

(The reason for some, but not all, of the items being ticked is explained on page 489.)

Secondly, the opening position must be ascertained. This normally takes the form of the previous Balance Sheet; if one was not prepared a year ago, the trader's financial position on that date must be ascertained as accurately as possible from such information as may be available. The excess of assets over liabilities will be the trader's capital.

For the purpose of this illustration it will be assumed that the following Balance Sheet as at April 1 is available:

S. E. TRADER

Balance Sheet as at April 1

	£	£		£
Capital Account		2,679	Lease of Premises at cost less depreciation	1,000
Sundry Creditors:	£		Fixtures and Fittings at cost less depreciation	400
Trade	√ 894		Delivery van at cost less depreciation	√ 120
Rent accrued	√ 50		Stock	1,300
		944	Sundry Debtors	√ 463
			Insurance paid in advance	√ 5
			Cash at Bank	√ 310
			Cash in Hand	√ 25
		£3,623		£3,623

Information must then be sought as to the usual closing adjustments. These are to be found as follows:

(1) Stock on March 31, £1,450; Sundry Debtors, £516; Sundry Creditors, £640.

(2) Rent payable accrued, £75; Rent receivable accrued, £25; Insurance paid in advance, £4.

(3) Depreciation to be written off: Lease, £50; Fixtures and Fittings, £20; Van, 20 per cent per annum on written down value.

It is also ascertained that during the year ended March 31, S. E. Trader incurred bad debts amounting to £80 and took goods from stock for consumption in his own household to the value (cost price) of £120.

All the foregoing constitutes the data from which a Trading and Profit and Loss Account and Balance Sheet are to be built up. It will be observed that the summary of receipts and payments and the opening Balance Sheet are both in debit and credit form and agree or balance. Each item in these two documents will, therefore, be required to be dealt with once only—as a debit if it appears on the credit side already, or vice versa.

The adjustments, on the other hand, are separate and unconnected items which do not balance. Each of these items must, therefore, be dealt with twice—once as a debit and once as a credit.

The first step, once the data has been completely assembled, is to convert the payments to suppliers and receipts from customers into purchases and sales respectively. For this purpose Total Creditors and Total Debtors Accounts are created as follows:

Total Creditors

	£		£
Cash	√ 7,941	Balance b/f	√ 894
Balance c/f	640	Purchases	7,687
	£8,581		£8,581

Total Debtors

	£		£
Balance b/f	√ 463	Cash	√10,208
Sales	10,341	Bad Debts	80
		Balance c/f	516
	£10,804		£10,804

The items "cash" and "balance b/f" in each of these accounts are ticked because they come from the receipts and payments summary or the opening Balance Sheet (in which the corresponding figures should be ticked) and, therefore, complete the double entry. The other items are left unticked as they still have to be carried into the final accounts. The values of purchases and sales are the amounts necessary to make the Total Accounts agree, all the other items, including the closing balances, being known.

Items in the Receipts and Payments Account which are subject to opening or closing adjustments can also be dealt with in skeleton ledger accounts, but after a little practice this should be unnecessary. As there is a loss on sale of the old van it will also be desirable to show a Van Account:

Rent and Rates

	£		£
Cash	✓ 270	Balance b/f	✓ 50
Balance c/f	75	P. & L. A/c	295
	£345		£345

Insurance

	£		£
Balance b/f	✓ 5	Balance c/f	4
Cash	15	P. & L. A/c	16
	£20		£20

Rent Receivable

	£		£
P. & L. A/c	75	Cash	✓ 50
		Balance c/f	25
	£75		£75

Van

	£		£
Balance b/f	✓ 120	Cash	✓ 40
Cash	✓ 400	P. & L. A/c	
		Depn. 6 mths 10 per cent on £120	12
		Loss on sale	68
		Depn. 6 mths 10 per cent on £400	40
		Balance c/f	360
	£520		£520

Drawings

	£		£
Cash	✓ 630	Capital A/c	810
Income Tax	✓ 60		
Purchases	120		
	£810		£810

The unticked items in the cash summary are now scrutinized and it is observed that they consist only of items such as:

(1) Wages and Salaries, Bank Charges, Sundry Expenses, and Interest on Investment, which are not subject to any adjustment and can, therefore, be taken straight into the Profit and Loss Account.

(2) The closing cash balance and bank overdraft which will go into their respective places in the Balance Sheet at March 31. (The opening cash balances were ticked against the corresponding items in the opening Balance Sheet.)

The only unticked items in the opening Balance Sheet are two fixed assets which, subject to deduction of depreciation, go into the closing Balance Sheet: Stock, which goes into the Trading Account, and Capital

Account, which will be dealt with in the Balance Sheet. The accounts can, therefore, be completed, as follows:

S. E. TRADER

Trading and Profit and Loss Account for the year ended March 31

		£		£
To Stock, April 1		1,300	By Sales	10,341
Purchases	7,687		Stock, March 31	1,450
Less own consumption	120			
		7,567		
Gross Profit, carried down		2,924		
		£11,791		£11,791
To Wages and Salaries		1,150	By Gross Profit, brought down	2,924
Rent and Rates		295	Rent Receivable	75
Insurance		16	Interest on Investment	50
Sundry Expenses		272		
Bank Charges		6		
Bad Debts		80		
Loss on sale of Van		68		
Depreciation: Vans		52		
Fixtures and Fittings		20		
Lease		50		
		2,009		
Net Profit transferred to Capital Account		1,040		
		£3,049		£3,049

Balance Sheet as at March 31

		£			£
S. E. Trader, Capital A/c			Lease, at cost less depreciation	1,000	
Balance at April 1	2,679		*Less* Depreciation written off	50	
Add Cash paid in (legacy)	200				950
Net profit for year ended Mar. 31	1,040		Fixtures and Fittings at cost less depreciation	400	
	3,919		*Less* Depreciation written off	20	
Less Drawings	810				380
		3,109	Delivery Van at cost	400	
Sundry Creditors:			*Less* Depreciation written off	40	
Trade	640				360
Rent accrued	75		Stock		1,450
		715	Sundry Debtors		516
Bank Overdraft		379	Rents Receivable accrued		25
			Insurance paid in advance		4
			Investment at cost		500
			Cash in hand		18
		£4,203			£4,203

The accounts are seen to be as full, in most respects, as those that would be prepared from a set of double-entry books and there is no reason why they should not be as accurate. The only essential record was the detailed account of receipts and payments; provided this was kept up during the year by the trader himself and he can give the value of debtors, creditors and stock-in-trade at the end of the year, the task of preparing the accounts can be entrusted to a professional accountant.

ESTIMATED ACCOUNTS

In the foregoing example of accounts prepared from incomplete records, the problem was considerably simplified by the presence of a complete account of receipts and payments, both of cash and bank transactions. It may sometimes be necessary to attempt to prepare accounts where even that fundamental record is lacking. In such a case the final result must depend largely upon estimates made by the trader himself. The procedure to be followed will depend partly upon the circumstances of the case, including the nature of the business carried on. As a first step, it is always necessary to build up an estimated summary of receipts and payments.

It will generally be found that, even though the trader has a banking account, the amounts paid into it will not reflect his takings in total. Many items of expenditure and the trader's personal drawings will probably have been paid out of the till.

The only reliable record in such a case is the Bank Pass Book or Statement. This is either written up into an analysed Cash Book or a complete analysis of it is made on paper ruled with a suitable number of columns. On the payments side the bank will record either the names of the payees to whom cheques have been issued or, in some cases, the numbers of the cheques only.

In the latter case it may be necessary to refer either to the cheque-book stubs or to the paid cheques returned by the bank, in order to ascertain the names. Receipted invoices and statements will then be examined for particulars of the payments, the majority of which (in number even if not in value) will be to suppliers of goods for resale. Some receipts will probably be missing and in such cases it will be necessary to rely on the trader's memory, fortified, if necessary, by reference to directories, which may establish the nature of the payee's business.

Little information is likely to be available as to the details of the amounts paid into the bank; in the absence of information to the contrary they will be listed as "cash banked." Any exceptionally large amount should be inquired into, as it may represent the sale of a capital asset or some non-trading item (such as a legacy received by the trader). In this way a reasonably accurate summary of the bank receipts and payments can be obtained.

It is next necessary to build up a statement of cash (as distinct from bank) payments. One item of this nature is already available in the bank summary; it is the total of cash banked during the year. In the course of identifying the cheque payments it is probable that some receipts will have been found for cash payments; these should have been listed on a

separate sheet. If wages have been paid out of takings it is probable that some sort of wages book will have been kept and P.A.Y.E. income-tax records may also be available. It should, therefore, be possible to build up a list of wages paid; any salary paid to the trader himself should be excluded but noted for the purpose of calculating his drawings.

Unless the trader has restricted his own drawings to a fixed and regular amount, the calculation of a total for the year is likely to prove difficult and will depend largely on the accuracy of the trader's own estimate. The amount taken into account in this way should be considered in relation to what is known about the trader's standard of living, the number of his dependants and the possession, or otherwise, of income from other sources.

Any other known, or estimated, expenses must be taken into account in order to obtain a complete summary of cash payments for the year. For example, in a small business, it may be found that the trader pays his shop rent weekly, out of the till, or has a slot meter for gas or electricity.

If the actual balances of cash in hand at the beginning and end of the year are not known they must be estimated (where the surplus takings are not banked daily, the number of days that have elapsed since the last banking should be taken into account here). It is unlikely that there will have been many cash receipts (as distinct from cheques paid into the bank) other than business takings, but if there were any that can be traced or that the trader can remember, they should also be taken into account. A summary of cash receipts and payments is then built up, the difference between the credit and debit sides being assumed to be the cash takings.

Example

Estimated Cash Receipts and Payments
for the year ended ——

	£		£
Cash in hand at beginning of year (as estimated last year)	20	Wages, as per Wages Book	300
Sale of old scales	5	Drawings as estimated	400
Balance, representing takings	4,005	Cash Banked	3,000
		Expenses and Purchases as listed from receipts	200
		Other expenses as estimated	100
		Cash in hand as estimated	30
	£4,030		£4,030

The following is a complete example which illustrates the method:

A, a shopkeeper, desires you to prepare accounts for the year ended March 31, 1945. No books have been kept but the following facts are ascertained:

(1) The Bank Pass Book showed lodgments during the year of £6,010 and withdrawals of £5,925.

(2) £500 had been placed on Deposit Account on December 31, 1943, at 2 per cent per annum and withdrawn with interest on June 30, 1944.

(3) £1,000 $3\frac{1}{2}$ per cent War Loan (interest receivable June 1 and December 1) had been purchased on April 10, 1944, for £1,050.
(4) The rent paid for the business premises was £100 per annum.
(5) The foregoing transactions and all payments for business purchases passed through the bank account. The takings were banked after meeting business expenses and personal living expenses.
(6) The assets and liabilities at March 31, 1945, were:

	£
Stock-in-Trade	550
Book Debts	575
Bank balance—credit	160
Private house—freehold	1,000
$3\frac{1}{2}$ per cent War Loan	1,050
Business liabilities	200

In the absence of reliable information, estimates are supplied by A on the following matters:
(1) that stock and book debts had each increased by £50 during the year;
(2) that the business liabilities were £100 at April 1, 1944;
(3) that personal expenses amounted to £400 during the year and business expenses to £250.

From the foregoing information you are required:
(1) To prepare a Profit and Loss Account of the business for the year to March 31, 1945;
(2) To prepare A's Balance Sheets as on April 1, 1944, and March 31, 1945. (*Chartered Accountants, Inter.*).

WORKING PAPERS

Summary of Bank Transactions

	£		£
Deposit withdrawn, June 30, 1944	500	War Loan purchased	1,050
Interest thereon	5	Rent	100
Interest on War Loan	35	Balance of withdrawals representing payment for goods purchased	4,775
Balance, representing cash banked	5,470		
	6,010	Total withdrawals	5,925
Balance, representing cash at bank, April 1, 1944	75	Cash at bank, March 31, 1945	160
	£6,085		£6,085

Summary of Cash Transactions

	£		£
Balance, representing total amount received from customers	6,120	Cash banked, as above	5,470
		Personal Expenses, estimated	400
		Business Expenses, estimated	250
	£6,120		£6,120

Total Debtors

	£		£
Book Debts, April 1, 1944 (estimated)	525	Cash received, as above	6,120
		Book Debts, March 31, 1945	575
Balance, representing sales	6,170		
	£6,695		£6,695

Total Creditors

Cash paid, as above	4,775	Liabilities, April 1, 1944	100
Liabilities, March 31, 1945	200	Balance, representing purchases	4,875
	£4,975		£4,975

A

Trading and Profit and Loss Account for the year ended March 31, 1945

	£		£
To Stock, April 1, 1944	500	By Sales	6,170
Purchases	4,875	Stock, March 31, 1945	550
Gross Profit, c/d	1,345		
	£6,720		£6,720
To Expenses	250	By Gross Profit b/d	1,345
Rent	100	Interest Received	40
Net Profit carried to Capital A/c	1,035		
	£1,385		£1,385

Balance Sheet as at March 31, 1945

1944			£	1944		£
	A, Capital Account			500	Stock	550
	As at April 1, 1944	£1,500		525	Sundry Debtors	575
	Add Net Profit	1,035			Investment £1,000 $3\frac{1}{2}$ per cent War Loan at cost	1,050
		2,535		500	(Deposit A/c)	
	Less Drawings	400		75	Cash at Bank	160
1,500			2,135			
100	Sundry Creditors		200			
1,600			£2,335	1,600		£2,335

Note. A's private house is not a business asset and it does not produce any interest that can be credited to Profit and Loss Account; it is, therefore, excluded from the Balance Sheets. The holding of War Loan, however, is regarded as the temporary investment of surplus business funds and is, therefore, brought into account together with the interest it produces.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) On January 1, Arthur Jones, a grocer, had the following assets and liabilities: Cash in Hand, £30; Cash at Bank, £320; Stock, £500; Fixtures and Fittings, £125; Sundry Debtors, £275; Creditors, £650.

During the half-year he drew £350 for his personal use. His assets and liabilities at June 30 were as follows: Cash in Hand, £25; Cash at Bank, £450; Stock, £525; Fixtures and Fittings, £140; Sundry Debtors, £360; Creditors, £520.

Prepare a statement showing Arthur James's profit for the half-year after writing off 10 per cent for depreciation on the above balance of Fixtures and Fittings and making a provision for Bad Debts of 5 per cent on the above balance of Sundry Debtors. (*L.C. of C. Certificate*).

(2) The following are the assets and liabilities, on the dates named, of AB, a merchant, who keeps no proper books of account. With the aid of these figures, and the notes given, you are required to prepare a Balance Sheet as on December 31, 1949, showing the net profit for the year.

	Dec. 31, 1948	*Dec.* 31, 1949
	£	£
Balance at bank in AB's favour	150	—
Bank balance (overdrawn)	—	75
Cash in hand	27	42
Stock	1,500	1,600
Debtors	350	500
Fixtures and Fittings	500	600
Creditors	130	90

Notes. (*a*) Of the debtors on December 31, 1949, £25 is to be written off as bad. (*b*) £100 was spent on new Fixtures and Fittings on June 30, 1949. All Fixtures and Fittings are to be depreciated at the rate of 10 per cent per annum. (*c*) AB has, during the year, drawn out £100 in cash for his private purposes. (*R.S.A. Stage II*).

(3) John Evans keeps his books on a single-entry basis. He does not keep a Bought Day Book but pays his suppliers on the basis of their monthly statements, first checking these with the invoices.

You are preparing accounts for the year to March 31, 1949, and ascertain that:

(*a*) The totals of the balances on the Bought Ledger, as on March 31, 1948, were £393 15s. (Cr.) and on March 31, 1949, £327 12s. 6d. (Cr.) and £15 10s. (Dr.).

(*b*) The total of payments during the year was £4,928 7s. 3d. and £75 8s. 9d. discounts were allowed, and

(*c*) Credits have been allowed by suppliers for amounts totalling £30 13s. 6d. for goods sold to them by Evans.

Write up a Total Account for the Bought Ledger for the year. (*Chartered Accountants, Inter.*).

(4) A trader who has not kept his books on the double-entry system asks you to prepare a Trading and Profit and Loss Account for the year ended December 31, and a Balance Sheet at that date. An analysis of the Cash Book provides you with the following information:

Dr.	£	*Cr.*	£
Receipts from Sundry Debtors	6,600	Balance due to Bank at Jan. 1	814
Cash Sales	150	Payments to Sundry Creditors	2,750
Capital introduced	400	General Trade Expenses	1,100
		Wages	1,705
		Drawings	330
		Balance at Bank at Dec. 31	440
		Cash in hand	11

You are also able to ascertain the following particulars:

	Jan. 1	*Dec.* 31
Sundry Debtors	£5,830	9,680
Sundry Creditors	1,650	2,145
Stock on hand	1,870	2,090
Machinery and Plant	2,200	2,200
Fixtures, etc.	154	154

The trader's capital at Jan. 1 was £7,590.

Depreciate Machinery, etc., by 10 per cent, Fixtures, etc., by £9, and make provision for Bad and Doubtful Debts of 5 per cent on the Sundry Debtors. (*A.C.C.A. Inter.*).

(5) FG, a tradesman, instructs you to prepare a Profit and Loss Account for the year ended December 31, 1948, and a Balance Sheet as on that date. The only book he has kept is a rough record of credit sales and a memorandum of cash drawings and expenses paid in cash. All his takings have been banked except amounts retained for personal drawings and cash expenses, which his notes show to have been £200 and £250 respectively.

The amounts owing to him for credit sales at January 1, 1948, were ascertained to be £78. There were no records of stock or liabilities at that date, but he was of opinion that the trade creditors were about the same as at the end of the year. There was nothing due for expenses at January 1, 1948. £300 had been spent on business premises and fittings prior to January 1, 1948.

All his purchases of goods for resale were paid for by cheque and he informs you that all sales were at a price which would show a uniform profit of 25 per cent on selling price. He had taken goods from stock for private consumption, the estimated cost of which was £150.

The Bank Pass Book showed a balance at January 1 of £70, lodgments during the year £6,600 and withdrawals £6,480. Included in the lodgments was £900, the proceeds of investments realized and brought into the business at that figure, and the withdrawals included £1,200 expended on the business premises and £350 for business expenses.

The following further information is supplied:

Assets at December 31, 1948—Book Debts £168, Stock at cost £1,300.

Liabilities at December 31, 1948—Trade Creditors for Goods £300, Creditors for Expenses and Accruals £80.

You are required to construct from the foregoing information: Cash Account, Sales and Purchases Accounts, Profit and Loss Account, Balance Sheets at December 31, 1947 and 1948. (*Chartered Accountants, Inter.*).

(6) Jones & Co., who sell bicycles and wireless sets, prepare accounts annually to September 30. On February 24, 1947, their stock was partially destroyed by fire, all records and books, however, being saved.

You are instructed to estimate the amount of the loss for the purposes of an insurance claim, and examination of the books discloses the following information:

	Bicycles £	*Wireless Sets* £
Value of stock at September 30, 1945, taken at cost	1,461	728
Value of stock at September 30, 1946, at cost	1,732	855
Purchases:		
Year to September 30, 1946	4,777	3,022
Period from October 1, 1946, to February 24, 1947	1,661	1,807
Sales:		
Year to September 30, 1946	5,635	3,860
Period from October 1, 1946, to February 24, 1947	2,175	1,980

The value of the salvaged stock immediately after the fire was: Bicycles, £1,220; Wireless sets, £362.

From the above information you are required to estimate the value of the stock destroyed by the fire, stating clearly the nature of any assumptions you may find it necessary to make. (*L.C. of C. Higher*).

(7) Explain concisely the essential points of difference between a Receipts and Payments Account and an Income and Expenditure Account.

(*Chartered Accountants, Inter.*).

(8) The following were the assets and liabilities of the XY Sports Club on March 31, 1949:

		£	s.	d.
Assets—	Furniture and Fixtures, valued at	260	0	0
	Sports Equipment	117	10	0
	Stock of Stationery	5	12	6
	200 National Savings Certificates, at cost	150	0	0
	Balance at Bank and Cash in Hand	45	18	8
		£579	1	2

		£	s.	d.
Liabilities—	Subscriptions for 1949/50 received in advance	12	12	0
	Quarter's rent of sports ground	18	15	0
	Quarter's telephone	4	8	9
		£35	15	9

The following is a summary of the treasurer's Cash Book for the year ended March 31, 1950:

Receipts	£	s.	d.	*Payments*	£	s.	d.
Balance in hand, March 31, 1949	45	18	8	Rent of Ground	75	0	0
Members' Subscriptions, 1949/50	460	18	0	Wages of Groundsman	225	0	0
Members' Subscriptions, 1950/51	16	16	0	Secretarial Expenses (Postage, Stationery and Telephone)	36	14	7
Sale of dance tickets	126	7	6	Purchase of Sports Equipment	56	16	0
Donations	10	12	6	Purchase of 75 National Savings Certs.	37	10	0
				Affiliation Fees	12	15	0
				Match Expenses	58	17	6
				Dance Expenses:			
				Hire of Bands	58	10	0
				Hire of Hall	18	8	0
				Refreshments and Incidentals	37	13	4
				Balance in hand, March 31, 1950	43	8	3
	£660	12	8		£660	12	8

You are required to prepare the Club's Income and Expenditure Account for the year ended March 31, 1950, and Balance Sheet as on that date, taking into account the following information and instructions:

(*a*) The net profit or loss from the dances is to be disclosed.
(*b*) The last dance had been held on March 29. It is ascertained that the proceeds of tickets for this dance, amounting to £39 7s. 6d., were in the hands of the organizing secretary on March 31. The treasurer had paid out the various expenses in connexion with the same, except the hire of the hall £5.
(*c*) £15 is to be provided for depreciation of furniture and fixtures.
(*d*) The sports equipment in hand on March 31, 1950, was valued at £132, and the stock of stationery at £4 5s.
(*e*) Accounts outstanding at March 31, 1950, were: Rent £18 15s., Telephone £4 13s. 2d.

(*R.S.A. Stage III*).

CHAPTER XX

COST ACCOUNTS

COST ACCOUNTING (or costing) is the application of the principles of accountancy to ascertaining the costs of individual units of production. It thus differs considerably from the ordinary processes of double-entry book-keeping, which are concerned primarily with the recording of assets and liabilities and with ascertaining the profit or loss of all the trading operations in total for a comparatively long period.

Costing is a technical process the details of which must depend upon the nature of the business involved. Cost accounting has become a separate profession, followed by cost accountants as distinct from book-keepers and financial accountants. It is not possible in one chapter to deal with many points of detail as they affect different industries; the examples that are given must therefore be considered as applications of the general principles which are common to nearly all systems of costing.

These principles are, in any case, more important than the detailed routine of cost recording, because they lead to a proper understanding of production problems with which most industries are, at times, faced. Many of these problems are concerned with the distinction between fixed and variable costs. The study of double-entry book-keeping shows that unless sufficient gross profit can be carried down from the Trading Account to cover the overhead expenses that are debited in the Profit and Loss Account, the final result will be a net loss.

Costing shows that production (which ultimately produces gross profit) is mainly dependent on variable costs (that is, costs, such as direct wages and materials consumed, which vary directly or more or less directly according to the level of output) but that the many non-variable costs (termed overheads, standing charges or establishment charges) that are inevitably incurred are all part of the total cost of production, to be expressed as an addition or "oncost" to the variable costs.

AIMS AND USES OF COSTING

Any system of costing is a waste of time and effort unless it serves some useful purpose. There is no point in ascertaining the cost of a certain unit of production if no use is to be made of that information. In any system of competitive trade and enterprise, however, it is obvious that such information must at times be essential to the survival of the undertaking. Without a cost system it is necessary to await the preparation of 1. the financial accounts to see whether the operations of a comparatively long period (usually one year) have been profitable or not; these accounts, however, do not disclose the results of individual operations.

Annual accounts which reveal a net profit may conceal the fact that 2. certain undertakings have been carried on at a loss. The preparation of Departmental Accounts (see Chapter XVII) may do something to remedy this state of affairs, but such accounts suffer from the handicap that is

common to all annual accounts—they give information at a date which, from the point of view of management and control, is too late for full use to be made of it. Financial or annual accounts are, in fact, mainly "historical" documents prepared by those who are responsible for the administration of a business as an account of their stewardship.

If, therefore, a costing system can reveal the results of individual jobs or operations at frequent intervals, this information may enable a decision to be taken which will cut short an unprofitable activity at a much earlier date than would otherwise be possible. It will also be possible to concentrate upon production of those articles which produce the greatest profit, to effect economies where they are shown to be most needed and to reduce wastage and inefficiency to a minimum.

The detailed records upon which a costing system is based may in some respects have a utility which far exceeds their original purpose. For example, costing demands some system of recording the consumption of materials (often in small quantities) as compared with the purchase of them (possibly in bulk) as recorded in the financial books. This entails the introduction of a proper system of stores control which, besides providing the information required by the cost accountant, encourages efficiency in buying, handling and storing the materials and reduces to a minimum wastage and pilferage of stocks. In fact, many of the processes of costing are linked with the principles of factory management.

In all the foregoing respects cost accounts do not replace the financial accounts; they amplify and anticipate them. Cost accounting is normally quite distinct from financial accounting and does not constitute part of the double-entry book-keeping system. The relationship between the two systems and the reconciliation of the results shown by them will be considered in more detail hereafter. It may be noted as one of the uses of a costing system, however, that in many undertakings it would be impossible without one to prepare accurate valuations of work-in-progress and stocks at the end of the financial year, and without such valuations it would not be possible to prepare accurate financial accounts.

COSTING AND ESTIMATING

One of the advantages of a reliable costing system is that it enables estimates or tenders for new work to be prepared with much greater accuracy than would otherwise be possible. As the margin of error in tendering is thereby reduced it should be possible to quote a finer price and thus obtain a larger volume of orders, leading in turn to greater efficiency in production and further reduction in costs, to the mutual advantage of the concern and of its customers. The use of costing in this way sometimes leads to confusion between the two distinct processes of costing and estimating. It should be emphasized, therefore, that: 3.

Costing is the process of ascertaining the *actual* cost of something that has already been produced or is in course of production (that is, it is the allocation of costs already incurred to individual units of production), whereas

Estimating is the process of computing in advance the probable cost of producing something in the near future.

While it may be possible (given the necessary technical knowledge of the processes involved and of the current costs of labour and materials which enter into those processes) to make estimates without the help of a costing system, estimates so made are liable to prove somewhat wide of the mark, particularly in regard to the provision for indirect or overhead expenses. Estimates based on recent and accurate costings of similar operations, adjusted where necessary to give effect to known changes in those costs (for example, when higher rates of wages come into effect in the industry) will usually prove much more satisfactory. The most direct relationship between estimates and costs is found in a system of budgetary control, where the comparison of the actual and estimated figures is made an integral part of the costing system.

If recent costings are to be used as a normal feature in estimating or tendering for new work it is essential that they should be up to date. A comparatively simple system which, although not theoretically exact in every respect, is easy to operate and always up to date is therefore to be preferred to one which is so full and complicated that individual costs cannot be computed until they are several months old. The same argument can be supported on other grounds. If all the costs of a business have to be recovered, in one form or another, as part of the total cost of production, the cost of operating the costing system is itself part of the total cost of producing. An over-elaboration of the system will therefore lead to an increase in costs which more than outweighs the savings and efficiencies that are effected by it. No cost system should be extended to a point where it becomes the master and not the servant of the business.

THE UNITS OF PRODUCTION

The unit of production to which any given costing system has to be related may be something which is made or created in the physical sense (for example, a house built) or a service that is rendered (for example, a transport service). Systems of costing fall, in fact, into two main classes:

(1) Those which ascertain the cost of each of several units produced during a given period (for example, each of several houses on different sites, being built by a builder or contractor).

(2) Those which measure the cost of a certain operation for a comparatively short period (usually a week) and compare that cost with the total output of that period, the first figure being divided by the second in order to find what, in effect, is the average cost per unit of production (for example, the cost of operating an omnibus service for a week, divided by the number of passenger-miles operated in that week to give the cost per passenger mile).

The first class can be of application only in those businesses which involve some degree of physical production. Such costs are known as Job or Terminal Costs, but it does not follow that it is possible or expedient to apply them to every productive process. For example, an iron foundry is engaged in the production of iron castings, pig iron being used as the raw material. Many different castings may be produced from one melt of metal and it may not be practicable to identify the wages of workmen with the individual castings on which they are collectively engaged.

Costing is therefore usually restricted to Single or Output Costs, which summarize the costs of a week and compare them with the total output of that week. When this total cost has been expressed at so much per cent of output it can then be applied to any individual casting by reference to its weight. This is in effect an average cost; it cannot be regarded as the actual cost of that particular casting.

Any operation involving a more or less continuous process (such as oil refining) is also costed primarily by reference to a period of time rather than to a physical unit of output. The cost per unit is again obtained by dividing total production into total cost. Such costs are known as Process Costs.

DIRECT AND INDIRECT COSTS

When a costing system is to be designed to fit a particular business and a suitable unit of production has been chosen, it becomes apparent that the total expenditure which has to be accounted for falls into two main groups:

(1) *Direct costs* which are incurred specifically in relation to one particular unit of production and can be identified with it (for example, the wages of building operatives working on one particular house and the cost of materials delivered to the site and actually built into that house).

(2) *Indirect costs*, which cannot be allocated in the above way but are nevertheless part of the total cost of production since they will have to be met out of the gross takings of a period before any net profit can be said to have been earned.

The division of expenses into direct and indirect costs follows roughly the distinction between a Trading (or Manufacturing) Account and a Profit and Loss Account. The most important items of direct expenditure are materials and wages, but it does not follow that all materials consumed and all wages paid can be costed as direct expenses. The essence of direct expenditure is that it is capable of identification with individual units of production and, in relation to costing, that it is expedient to make this allocation.

In order to allocate wages as a direct expense, it must be possible to keep a detailed record of the different jobs or units upon which each employee is engaged and to allocate his time (and, therefore, the cost of that time in wages paid) to each job or unit of production. The total of wages paid, however, may include the wages of, say, storesmen, crane-drivers and the like whose work is concerned with the output of the factory as a whole and whose pay cannot be identified with separate units of production. Wages paid to such employees are an indirect expense which must be recovered by some form of oncost addition to the direct charges.

Similarly, materials of little intrinsic value used in comparatively small quantities may be costed as indirect expenditure even though it might be theoretically possible to measure them exactly. Cottons and threads used in clothing industries provide a case in point. In theory the amount used in one particular garment could be measured and costed but the resulting

gain in accuracy would be negligible and would be far outweighed by the additional clerical labour (and thus cost in overheads) that would be involved.

Some items of direct expenditure do not fall under the headings materials or wages; they are direct expenses. The test, as before, is the possibility and expediency of identifying them with individual items of production. For example, a builder may pay architect's or surveyor's fees in connexion with the erection of one particular house; such fees can be regarded as a direct cost, whereas in most other businesses professional fees would come into overheads or indirect expenditure.

PRIME COST

The total of the direct costs attributable to one unit of production is generally known as Prime Cost. The chief importance of this figure lies in the fact that it is the total of costs that can be identified with a unit of production. If the records have been kept correctly this total can be regarded as an accurate statement of fact.

Many further items of expenditure may have to be taken into account before the complete cost of production is shown, but these additional charges, or oncosts, must contain some element of estimation. Unless this is borne constantly in mind the complete costs can prove incorrect and misleading. This is particularly so at the times when accurate figures are most necessary; for instance, when exceptional conditions make it impossible to maintain the expected rate of production upon which the oncost calculations have been based.

For the foregoing reason it is sometimes urged that attempts at detailed costing should stop short at prime cost, indirect expenditure being regarded as something that has to be recovered from the total production of the year rather than from individual units. Where the proportion of direct expenditure to total expenditure is high this argument may be sound but where, as in many highly mechanized processes, the contrary prevails, it should be recognized that prime cost is, at best, only a half-way stage in the calculation of total cost.

The general principles involved in recording prime cost under its three constituents—materials, labour and direct expenses—are considered fully later in this chapter.

INDIRECT COSTS

If it is desired to carry costing calculations beyond the prime cost stage, indirect charges (or overheads or establishment charges as they are sometimes called) are added to the direct costs according to some prearranged formula or system. For this purpose, the overhead expenses are generally considered in several distinct groups, as follows:

(1) *Factory or works expenses* other than those already dealt with as direct costs. Indirect wages and materials, salaries of the works manager and other factory staff (as distinct from general office staff), the rent, rates, lighting and heating and other expenses of the factory itself (again excluding general office buildings or warehousing accommodation for finished stock) and the expense, including depre-

ciation, of operating the factory machinery, will normally provide the principal items under this heading. All such expenses, although indirect, are much more definitely a part of the cost of producing the output of the factory than are the further expenses falling into the next two categories. These works or factory expenses have to be added to prime cost to find the Works Cost of any particular unit.

(2) *General administration expenses* other than those already taken into account as works expenses, or others which fall into the next group as selling expenses. General office salaries, office rent, rates, lighting, heating and other office expenses, printing, stationery, postage, telephone and similar general overhead expenditure, including depreciation of office equipment, all fall into this group. If the organization is a limited company, directors' salaries and fees will normally be regarded as a general administrative expense, except that the salaries of directors who hold executive positions such as works managers and sales managers will be classified according to the nature of the service rendered. Dividends payable to shareholders, on the other hand, are an appropriation of profits and as such will not be taken into account in costing.

General administration expenses are sometimes referred to as office expenses, to distinguish them from works expenses. Provided they do not include any selling or distributive expenses they can be regarded as a further part of the total Cost of Production. Cost of production is then works cost plus office expenses.

(3) *Selling and distributive expenses* are preferably excluded from general administration expenses as they relate to the sale of goods rather than to their production. Unless the whole of the production is sold immediately it is completed the goods sold in a given period will not be entirely the same as those produced during that period. Thus, if the stocks of finished goods have increased during a certain year, the volume of goods sold (in quantity as distinct from value) is less than the volume of goods manufactured. If the selling expenses, through being included in the general administrative expenses or office oncost, are related to the production of the period this will give a false impression of the actual cost of selling the smaller number of units that were actually sold.

Salaries and expenses of travellers, operating costs of delivery vans, including drivers' wages and depreciation, carriage outwards and warehouse expenses generally will be the chief items to be grouped under this heading. Expenses of promoting sales, such as advertising, exhibits at trade fairs and the like may also be included, as may bad debts, which can be regarded as a normal incident of selling goods on credit. The result of adding selling expenses to cost of production is to find the Cost of Sales, it being understood that this figure relates to goods sold during the year, which are not necessarily the same as those produced.

It will be observed that types of overhead expenditure considered under the three foregoing headings do not cover all the items that would

normally appear on the debit side of a Profit and Loss Account. In particular, they do not cover items of a financial nature such as bank interest, mortage, loan or debenture interest and cash discounts. This is because such items are dependent on the capital structure of the concern, and if interest on capital is to be taken into account at all it should be interest (calculated at a reasonable rate having regard to current financial conditions) on the total capital employed in the undertaking and not merely the amount of interest actually paid on as much of that capital as happens to have been borrowed from third parties.

The view generally held is that interest is part of profit and as such is preferably excluded from costings. There may be special circumstances, however, such as jobs or contracts extending over a long period of time, and involving the use of expensive special equipment and the locking up of capital in work-in-progress, where interest should be taken into account; such cases should, of course, be dealt with on their merits.

The difference between selling prices and cost of sales should be net profit but it is not to be expected that net profit calculated in this way will agree exactly with the net profit shown by the Profit and Loss Account for the same period. The exclusion from the cost figures of interest and other financial items will in itself lead to a difference. The Profit and Loss Account may also contain, on the credit side, items representing miscellaneous income not connected with the normal activities of the concern (for instance, interest and dividends received from the investment of surplus funds), while on the debit side certain exceptional and non-recurring items may sometimes appear; these from their nature can scarcely be forecast and taken into account in rates of oncost.

The normal methods of recovering oncost are based on two estimates:
(1) of the expenditure to be recovered in this way in the ensuing period;
(2) of the volume of the production on which it will be recovered.

It is, therefore, most unlikely that the total amount charged in the Cost Accounts for oncost will agree with the total of the relevant items in the Profit and Loss Account. Every effort should be made, by revising the oncost rates at frequent intervals, to ensure that this difference (which may represent either an over-allocation or an under-allocation of actual expenditure to estimated costs) is kept as small as possible.

MATERIALS

The chief problem involved in costing materials as one of the elements of prime cost is to convert the figures in the financial books representing materials *purchased* during a given period into the cost of the materials actually *consumed* during that period.

The problem is simplified where, as for example in the building industry, most of the materials required are purchased for specific jobs. It is then possible to provide the Bought Day Book with analysis columns which enable most of the inward invoices to be allocated to one job or another. These columns do not affect the double-entry book-keeping; for that purpose the invoices are still treated in total as purchases. They do, however, enable monthly entries to be made, in the Cost Ledger, of the direct purchases for each job. If the number of jobs current at any one

time is too great it is not possible to provide an ordinary bound book with a sufficient number of analysis columns and it is then necessary to make a separate monthly abstract or analysis of the invoices. Certain forms of book-keeping machines are well adapted for this purpose.

MATERIAL STORES

Even if many of the purchases are direct purchases and can be dealt with as above, some materials will normally be bought in bulk, placed in some convenient store or yard and drawn upon as required. In some types of industry (such as light engineering) this may be the normal procedure for all materials purchased. The principles of good management and industrial control demand that the purchase, storage and distribution of such materials should be strictly supervised. From the point of view of the cost accountant, the following are essential:

(1) Efficient supervision of the stores of material on hand at any time so that the necessary records can be maintained.

(2) Some sort of "account" for each type of material kept in store, for recording the receipt and issue of that material (and, consequently, for recording the balance unissued at any time).

(3) Liaison between the Bought Ledger department and the Stores department so that all materials purchased are recorded at cost in the appropriate accounts and to ensure that only those materials that have actually been received into the store are paid for.

(4) A proper system of requisitioning materials required to be issued from the store so that (*a*) the appropriate stores account can be credited, and (*b*) the job or process which uses the material can in due course be charged accordingly.

(4) A system of stock-taking at regular intervals so that the actual stock in hand at any time can be compared with the balance on the stores account (which shows how much ought to be on hand) and appropriate adjustments can then be made for any differences.

STOREKEEPER'S DUTIES

The storekeeper is usually concerned only with the quantities of each kind of material which passes through his hands. His primary duty is to maintain the stores in good physical condition and arranged in such a way that they can be issued immediately they are required. His other principal duties are:

(1) To check deliveries of goods against the accompanying invoice or delivery note, both as to quantity and quality, and to advise the Bought Ledger department accordingly.

(2) To issue goods only on receipt of a properly signed authority or Materials Requisition. This document will then be passed on to the Cost Office to form the basis of the appropriate costing entries.

(3) To maintain a record of the quantity of each type of material (*a*) received, (*b*) issued, and (*c*) in hand (that is, the balance of *a* and *b*).

It may also be made part of his duty to advise the buying department when stocks of a particular item reach a certain minimum level, so

that further supplies may be ordered. Alternatively, this duty can devolve upon the Cost Office, or the buying department can be provided with stock lists at frequent intervals.

MATERIAL REQUISITION FORMS

The following, which may of course be amplified or adapted to suit the requirements of any particular business, contains the essentials of a material requisition form:

XY Manufacturing Co., Ltd.

MATERIAL REQUISITION Serial No. ......

The Storekeeper is hereby authorized to issue materials as undernoted and to charge

....

Date.......... (Signed)........................
Works Manager

Quantity	*Description*	*Remarks*	*For use in Cost Office*			
			Price	*Amount*		
				£	s.	d.

Date issued.......... (Signed)................
Storekeeper.

For use in Cost Office.

Debit Job.......... Credit Stores Ledger......

It will be noted that the storekeeper is not required to decide the price at which the materials are charged to production; this part of the form is completed in the Cost Office. The various ways in which this price may be calculated are considered later.

MATERIALS RETURNED

Materials that were charged originally as direct purchases and are subsequently returned to the supplier, or for any other reason become the subject of a suppliers' credit note, will be recorded, in the financial books, in the Returns Outwards Book; for costing they will be dealt with in a way which is similar to, but in effect the reverse of, that accorded to direct purchases.

Materials returned to store, on the other hand, will not give rise to any entry in the financial books. They should be recorded on a Materials

Returned to Store form, which will be similar in design to the Materials Requisition form, except that it will be worded:

MATERIALS RETURNED TO STORE

The Storekeeper is hereby authorized to return to store the undernoted materials ex..........................

and the note at the bottom of the form "For use in Cost Office" will read:

Debit Stores Ledger.......... Credit Job........

These and other forms that are in frequent use should be printed on paper of different colours, in order to avoid confusion.

MATERIAL TRANSFERS

When materials found to be surplus to the requirements of one job can conveniently be used for another they should, nevertheless, be returned to store and then reissued to the other job, so that the requisite records of the transaction can be maintained. In the case of building or engineering contracts carried out at a distance from the store or yard, however, this might involve unnecessary handling and transport charges. If such materials can in fact be transferred to a nearby job, this can be permitted provided the transfer is properly recorded. The following would be a suitable form of Transfer Note:

A Building Co., Ltd.

MATERIALS TRANSFERRED Serial No. ......

The undernoted materials have been transferred from

Contract..........

Date.............. (Signed)......................

Foreman.

Quantity	*Description*	*Remarks*	*For use in Cost Office*			
			Price	*Amount*		
				£	s.	d.

The above materials have been received at

Contract...................

Date.......... (Signed)........................

Foreman.

The forms are usually made up on thin paper, in a triplicate book, one book being supplied to each foreman who is in charge of a contract. The top copy is sent with the goods that are transferred and the receiving foreman, after checking the quantities and description of the goods, signs the form and sends it to his head office (unless, as sometimes happens, the costing records are kept at the site). The second copy is sent to head office by the first foreman, to guard against the possibility of the top copy not being forwarded. The third copy remains in the book for reference if required.

Insistence on this or some similar routine is necessary if accurate cost accounts are to be kept and wastage or pilferage of surplus materials prevented.

BIN CARDS

In a well-equipped store the various kinds and sizes of material should be arranged, as far as possible, in separate receptacles or bins; the storekeeper's record of his stock of each article is, therefore, known as a bin card. A typical ruling is as follows:

XY Manufacturing Co., Ltd.

BIN CARD

Description....................

Stored in Block..........Aisle..........Bin..........

Minimum Quantity........ Maximum Quantity........

Received			*Issued*			*Balance*
Date	*Quantity*	*Supplier*	*Date*	*Quantity*	*Reqn. No.*	*Quantity*

The interval between the receipt or issue of stores and the making of the appropriate entry on the bin card should be reduced to a minimum and the revised "balance" figure should be inserted after each receipt or issue. The bin cards then constitute a form of perpetual inventory, showing the quantity of each article in store at any given time. This must be checked periodically against a physical stock-taking or count but it is not necessary that all stores should be checked on the same day.

STORES LEDGER

The Stores Ledger is similar to the bin cards in that it records quantities of materials purchased, issued and on hand, but it has to go further than that and convert those quantities into values. This involves a decision as to the basis upon which the materials issued to production are to be charged out. As the function of costing is to ascertain cost of production it might be thought that the obvious decision that materials are to be

charged out at cost would solve the problem; in fact, it merely raises the question "What is Cost?"

If the cost of all materials remained absolutely constant and they were never subject to losses in store from such causes as evaporation and breaking bulk there would be no problem; there would be only one cost price for each article and it would be issued at that price.

In fact, the costs of different batches of material purchased from time to time may vary considerably, while some materials may undergo substantial changes in quantity between the time of purchase and the time of issue. It is therefore necessary to consider several alternative methods of calculating issue prices.

ACTUAL COST

Where materials are purchased specifically for a particular job it is possible to identify their purchase price and to charge them out of store accordingly. This is, of course, an application of the principle of direct purchase, the goods merely being taken into store for convenience and safe custody pending their actual use on the job concerned.

FIRST IN—FIRST OUT

This is perhaps the most usual method of charging out goods from store where the actual cost price cannot be identified. It conforms to the principles of good storekeeping in that materials already in stock should be completely issued before new supplies are drawn upon. A Stores Ledger account written up on this principle might appear as follows:

Description....................... *Account No.........*

Date	Purchases			Issues			Stock		Notes
19—	*Quantity*	*Price*	*Value*	*Quantity*	*Price*	*Value*	*Quantity*	*Value*	
			£ s. d.			£ s. d.		£ s. d.	
Sept. 10	1,000	6d.	25 0 0				1,000	25 0 0	at 6d.
20				600	6d.	15 0 0	400	10 0 0	,,
Oct. 21	2,000	8d.	66 13 4				2,400	76 13 4	{ 400 at 6d. / 2,000 at 8d.
30				1,200 { 400 / 800	6d. / 8d.	36 13 4	1,200	40 0 0	at 8d.
Nov. 5				800	8d.	26 13 4	400	13 6 8	,,
Dec. 18	2,000	9d.	75 0 0				2,400	88 6 8	{ 400 at 8d. / 2,000 at 9d.
	5,000		£166 13 4	2,600		£78 6 8			
Jan. 1	2,400		88 6 8				2,400	88 6 8	

Note. The entries in the above account have been restricted to the minimum necessary to illustrate the principle of the first in—first out method of pricing. If the accounts are used as part of the system of stores buying and control the following additional facts could usefully be recorded:

(1) Names and addresses of usual suppliers.
(2) Name of supplier and invoice number of each batch.
(3) Requisition numbers for quantities issued.
(4) Materials on order not yet received.
(5) Quantities earmarked for specific jobs not yet requisitioned.

The first in—first out method can lead to inequitable and in fact misleading results if there are frequent and substantial changes in the prices. Thus, in the above example, the 1,200 units which were issued to a job on October 30 were presumably identical in the physical sense, but while 400 cost the job only 6d. each the other 800 were charged at 8d. If two different jobs had been involved, one drawing 600 units out of store on October 29 while the other drew 600 units on October 30, the respective charges to production could have been:

	£ s. d.	£ s. d.
To the first job, 400 at 6d. =	10 0 0	
200 at 8d. =	6 13 4	
		16 13 4
To the second job, 600 at 8d.		20 0 0

Although the two jobs were in production at virtually the same time, the second bears a substantially higher charge for an identical quantity of this material and will therefore tend to show a less favourable result.

AVERAGE PRICE

This method is designed to reduce the inequities involved in the first in—first out prices and results in all issues made between successive purchases being charged at the same average rate. A purchase of additional stores at a new price causes the average price to alter but the fluctuations are to a large extent reduced or "flattened out." The average-price method applied to the facts of the previous example would give the following result.

Description........................ *Account No.........*

	Purchases			Issues			Stock		
Date	*Quantity*	*Price*	*Value*	*Quantity*	*Price*	*Value*	*Quantity*	*Value*	*Average Price*
			£ s. d.			£ s. d.		£ s. d.	
Sept. 10	1,000	6d.	25 0 0				1,000	25 0 0	6d.
20				600	6d.	15 0 0	400	10 0 0	6d.
Oct. 21	2,000	8d.	66 13 4				2,400	76 13 4	$7\frac{2}{3}$d.
30				1,200	$7\frac{2}{3}$d.	38 6 8	1,200	38 6 8	$7\frac{2}{3}$d.
Nov. 5				800	$7\frac{2}{3}$d.	25 11 1	400	12 15 7	$7\frac{2}{3}$d.
Dec. 18	2,000	9d.	75 0 0				2,400	87 15 7	8·778d.
	5,000		£166 13 4	2,600		£78 17 9			
Jan. 1	2,400	8·778d.	87 15 7						

The chief disadvantage of this method lies in the fact that after a time the averages tend to involve awkward calculations and the prices contain odd fractions of a penny.

FIXED PRICE

When conditions are such that the prices at which materials are bought vary very little over comparatively long periods, it is possible to fix a price at which issues of each article are to be charged. Small fluctuations

in the actual cost price are then ignored but effect will have to be given to long-term changes in the price level by revising the issuing prices from time to time.

This method has the advantage of simplicity and avoids awkward prices such as may arise under the average-price method. Small differences will arise on the value columns of the Stores Ledger accounts; these must be written off at least once a year.

MARKET PRICE

It is sometimes urged that production ought to be charged with the market price of materials at the date when they are actually used. By market price is meant, of course, the price at which they could then have been bought.

Where this method of costing is adopted, the Stores Ledger accounts will reveal differences in the Value columns; a surplus or "profit" will arise when the entries on the issues side exceed those on the purchases side, and this will indicate that prices have risen between the dates of buying and using the materials.

Conversely, an excess of debits over credits would result from a fall in prices. The system is thus said to indicate the result of good or bad buying; this is a specious argument which ignores the fact that a buyer or store-keeper who ran down the stocks to a dangerously low level in order to "play the market" would be entirely responsible for any resulting loss in production.

In any case, the function of cost accounts is to show, as nearly as possible, what the cost of production has been; not what it might have been in different circumstances. Save in exceptional circumstances, therefore, the method is not to be recommended.

The following is an illustration of the working of the system based on the same facts as those recorded in the preceding examples, with the additional assumption that market values on the dates of issue were as shown:

Description....................... *Account No.........*

	Purchases			*Issues*			*Stock*		
Date	*Quantity*	*Price*	*Value*	*Quantity*	*Price*	*Value*	*Quantity*	*Price*	*Value*
			£ s. d.			£ s. d.			£ s. d.
Sept. 10	1,000	6d.	25 0 0				1,000	6d.	25 0 0
20				600	7d.	17 10 0	400	7d.	11 13 4
Oct. 21	2,000	8d.	66 13 4				2,400	8d.	80 0 0
30				1,200	8d.	40 0 0	1,200	8d.	40 0 0
Nov. 5				800	8d.	26 13 4	400	8d.	13 6 8
Dec. 18	2,000	9d.	75 0 0				2,400	9d.	90 0 0
31				2,400	9d.	90 0 0			
	5,000		166 13 4	5,000		174 3 4			
	Surplus		7 10 0						
			£174 3 4			£174 3 4			
Jan. 1	2,400	9d.	90 0 0				2,400	9d.	90 0 0

It may be noted that for consistency of the costing records, the balance on hand on December 31 is carried down at the market price then ruling, 9d. per unit. As to 400 of the units included in this balance, these are in excess of cost and it would not therefore be possible to say that the stock of raw materials was valued at the *lower* of cost or market values. For the purpose of the Balance Sheet and financial books and accounts it will thus be necessary to revise the valuation of the stock of stores, in order to eliminate any such errors of principle.

INFLATED OR EFFECTIVE PRICE

This method is suitable where losses (or occasionally gains) in store are inevitable. The usual causes of such differences are:

(1) Evaporation or absorption of moisture leading to loss or gain of weight respectively.

(2) Inherent vice in the material, leading to deterioration and rejection of some of the stock.

(3) Breaking bulk, as, for example, in cutting timber or window glass; however skilfully this is done some wastage is inevitable.

Where experience shows that these losses tend to amount to a fairly regular percentage of the quantity originally taken into store, the issue price can be calculated so as to take that percentage into account.

Example

If the cost of certain timber purchased by a builder and taken into stock at his yard is 7s. 11d. per cubic foot and losses in cutting normally amount to 5 per cent, then 100 cu. ft. purchased at a cost of 100 × 7s. 11d. = £39 11s. 8d. will produce 95 cu. ft. of finished joinery.

The cost accounts of the jobs for which the timber is used should, therefore, be charged at the rate of

$$\frac{\text{£39 11s. 8d.}}{95} = \text{8s. 4d. per cu. ft.}$$

This percentage "loading" can be applied to any of the methods already considered except the actual cost method. Where actual cost is taken, the job will be charged with the whole cost of the bulk purchase and will thus automatically bear the cost of any wastage.

LABOUR

The costing of labour as the second element of prime cost involves the calculation of the effective cost of all labour that can be identified directly with production. Indirect labour which cannot be identified in this way is normally dealt with as one of the constituents of oncost.

So far as direct labour is concerned, the chief problems are:

(1) To identify the total time for which each direct worker is paid with the jobs on which he was engaged during that time.

(2) To calculate his effective rate of pay so that the time identified with particular jobs can be valued and costed.

TIME RECORDS

Identification of the workers' time involves the keeping of detailed time records. These normally take the form of time sheets kept by the workmen themselves and handed in, through their foremen, at the end of each pay week. Alternatively (and this is particularly suitable where men work in gangs on the same job), the time records can be kept by the foreman.

The time sheets are normally quite distinct from the gate records of the daily hours worked, from which the pay due to each employee is calculated. The gate records (often in the form of clock cards) do not then form part of the costing system; they should nevertheless be compared with the time sheets and the hours agreed in total. Idle time may sometimes occur, due to some hold-up in the supply of materials, machinery breakdowns, and other reasons, and this should be indicated on the time sheets of the men concerned.

In order to avoid entering an unnecessary amount of detail in the account which records the cost of each job, it is necessary to convert the detailed time sheets into one weekly total for each job. This is usually done by abstracting the figures and summarizing them on a Direct Labour Summary Sheet, which might be ruled as follows:

DIRECT LABOUR SUMMARY Week ended........

Job No.........				*Job. No.........*				*Job. No.*
Name or Number	*Hours*	*Rate*	*Amount*	*Name or Number*	*Hours*	*Rate*	*Amount*	*etc., etc.*
		s. d.	£ s. d.			s. d.	£ s. d.	

EFFECTIVE PAY

The basis of pay of workmen engaged directly in production is usually an hourly rate. Where a fixed weekly amount (subject possibly to additions for bonus or overtime) is paid in conjunction with a guaranteed week of so many hours, the equivalent rate per hour can be calculated quite easily. In addition to the pay worked out at so much per hour or per week, however, the pay sheet (showing how much money has to be drawn from the bank for payment of wages) will probably contain some or all of the following:

(1) Employer's contributions to National Insurance.

(2) Workmen's expenses (such as "tool money") and, in some cases, subsistence.

(3) Holiday payments (under holidays-with-pay schemes).

Other expenses which may be borne by the employer and which are directly related to the wages paid are:

(1) Pension fund contributions.

(2) Employers' Liability Insurance premiums.

(3) Contributions to various welfare schemes.

These may all have to be taken into account in order to determine the *effective* rate of wages paid to each class of operative per hour. On the other hand, deduction from gross pay for employees' contributions to National Insurance, P.A.Y.E., pension fund contributions and the like can be disregarded as they have to be accounted for to the appropriate authority and therefore do not reduce the effective cost of labour.

When overtime is worked, payment is normally made at a rate which exceeds the basic rate (or the time paid for is increased to time-and-a-quarter, time-and-a-half, and so on, which is really the same thing as paying a higher rate for the hours worked). If overtime charges are incurred for one specific job, that job should bear the whole of the resulting increase in labour cost. On the other hand, where overtime is worked because of the general high level of production it would be unfair to charge a job which happens to be done in overtime at a higher rate than that applicable to production as a whole. The same argument applies where shift working, at differential rates of pay, is resorted to. In such cases the problem is to compute an average effective rate of pay.

The additional labour costs over and above the normal hourly rate of pay can be charged to production in either of the following ways:

(1) By calculating an *effective* rate of wages for each type of employee for each week.

Example

The basic pay of certain tradesmen for a week of 40 hours is 3s. per hour. The total pay issued to tradesmen of this class for one week in a certain undertaking was calculated as follows:

	£	s.	d.
400 hours at 3s. per hour	60	0	0
100 hours at 3s. 9d. per hour	18	15	0
	78	15	0
Employers' Contributions to National Insurance, Holidays with Pay, Pension Fund, etc.	6	5	0
	£85	0	0

$$\text{Effective rate per hour } \frac{£85}{500} = 3s.\ 4{\cdot}8d.$$

This method may be theoretically exact, but it involves detailed weekly calculations and the effective rates may vary substantially from one week to another. Many authorities contend that prime cost figures should be based on normal production, variations due to abnormal conditions (for example, under-production coupled with payment for a guaranteed week, or over-production coupled with payment of bonus or overtime rates) then being shown separately.

(2) By charging production at the basic hourly rate of pay, all additional items being included in works indirect expenses and therefore recovered separately as oncost. This has the merit of simplicity and overcomes the burden of recalculating the effective rate each week. Charges in the basic rate must, of course, be reflected immediately in the rates at which labour is charged to prime cost.

ONCOST

If costings are required to be carried beyond the prime cost stage, overhead or indirect expenses have to be recovered by adding oncost to prime cost.

The nature of the items of indirect expenditure to be taken into account and their division into groups (Works Indirect Expenses, Office and Administration Expenses, and Selling Expenses) has been considered already. When the total expenditure under any one of these headings has been calculated or estimated by reference to the financial books and accounts (known or expected changes in the level of future expenditure being duly allowed for) the chief problem still remains; it is how to allocate this total expenditure to individual units of production.

PERCENTAGE METHODS

The simplest methods of allocating oncost involve the addition of an appropriate percentage either to prime cost or to one of the elements of prime cost. There are thus three alternatives:

(1) *Percentage on direct materials*. This has the merit of simplicity and, when the cost of the raw material put into a job can be taken as a fair indication of its size and duration, it may give reasonable results. In most cases it is open to the objection that it does not pay sufficient attention to the time element.

Where the percentage is calculated on the cost of materials consumed, differences in the prices of alternative materials may lead to serious inaccuracies. For example, a manufacturing goldsmith and silversmith who recovered his overheads as a percentage on the cost of materials would thereby overburden the articles made of gold and under-cost those made of silver. This disadvantage might be reduced, however: (*a*) by basing the oncost rates on the *weight* of precious metal used or (*b*) by departmental analysis.

(2) *Percentage on direct labour*. This also is a simple method and, since wages are usually paid on a time basis, it is one which takes into account the time spent on the production of each unit. It tends, however, to attach an unduly high proportion of overheads to the higher rates of wages paid to skilled operatives and to undercharge jobs carried out at lower rates of pay by unskilled workers. As the unskilled worker usually takes longer to complete his section of the work and requires more supervision (the cost of which, as indirect labour, is included in the oncost), such work ought to bear a heavier proportion of the overheads.

(3) *Percentage on prime cost*. This method is, perhaps, the simplest of

all, but it cannot be regarded as any more accurate than either of the foregoing methods; indeed, it may be said to combine the inaccuracies of each.

Different types of oncost need not necessarily be recovered by the same method. Thus, works expenses are intimately associated with the manufacturing processes in which direct labour is engaged; works oncost is therefore most commonly expressed as a percentage on direct labour. Office and general administration expenses, on the other hand, are associated with all the activities of the business, including, for example, office expenses connected with the purchase of materials as well as with the payment of wages. Office oncost is therefore most commonly expressed as a percentage on prime cost and is thus made dependent on all the items of direct expenditure. A typical cost statement based on assumed figures and rates of oncost would then be as follows:

COST SHEET

	Job No......
	£
Direct Materials	80
Direct Labour	120
Direct Expenses (detailed)	40
Prime Cost	240
Works Oncost, 50 per cent on Labour	60
Works Cost	300
Office Oncost, 10 per cent on Prime Cost	24
Cost of Production	£324

HOURLY CHARGES

If the percentage methods of recovering oncost are not thought to be sufficiently accurate, some alternative must be found. This generally recognizes that most overheads accrue on a time basis; for example, the rent of a factory or a particular part of a factory for two days is double the rent for one day, and so on.

It is not sufficient to consider the time factor alone, however. Two jobs might both be finished in the same period of four days but if one of them represented the work of two men while ten men had been engaged on the other, it would be illogical to make each bear the same amount of oncost. It may be inferred that the job on which the larger number of men worked occupied a greater space, required more supervision and generally attracted a greater proportion of overhead expenditure.

Two methods are available which give effect to both these factors:

(1) *The labour-hour rate*. The total amount to be recovered as, say, works oncost during a given period is compared with the total number of hours expected to be worked by direct labour during that

period. The second figure divided into the first then gives a labour-hour rate which can be applied to the costing of any individual job.

If the cost of direct labour applicable to each job has been summarized on the form of Direct Labour Abstract already illustrated, the totals of the Hours columns will provide the necessary information for allocating oncost on a labour-hour basis.

(2) *The machine-hour rate.* The tendency for machine labour to replace hand labour (or craftsmanship) is reflected in costing by the application of machine-hour rates where labour-hour rates would formerly have been appropriate. The method is a great improvement on most others in that many items, including depreciation of the machine itself, which would otherwise be included in works oncost and thus spread over the production of the whole factory, can be identified with one particular machine and then costed as, in effect, a direct charge. If one or more operatives attend the same machines exclusively, their wages can also be included in the machine-hour rate, which then takes the place of a direct labour charge.

Example

S.A., Ltd., use two identical large and four identical small machines. Each large machine occupies one-quarter of the workshop and fully employs three workers; each small machine occupies half the space of a large machine and fully employs two workers. The workers are paid by piece-work.

Each of the six machines is estimated to work 1,440 hours per year, while the effective working life is taken as 12,000 working hours for each large machine, and 9,000 working hours for each small machine. Large machines cost £2,000 each and small machines £400 each. Scrap values are £400 and £10 respectively.

Repairs, Maintenance and Oil are estimated to cost for each large machine £400 and each small machine £120 during its effective life.

Power consumption costs 1d. per unit and amounts for a large machine to 20 units per hour and for a small machine to 2 units per hour.

The manager is paid £480 a year and workshop supervision occupies half his time, which is divided equally among the six machines.

Details of other expenses are:

Rent and Rates of workshop		£640 a year
Lighting	to be apportioned in the ratio of workers employed	140 „ „
Heating		42 „ „

Taking a period of three months as a basis, calculate to the nearest penny the machine-hour rate for a large machine and a small machine respectively to be added to wages costs in order to ascertain manufacturing costs.

(*Chartered Accountants, Final*).

S.A. Ltd.

Calculation of Machine-hour rates for 3 months ending......

(1) *Large Machines*

		£ s. d.
Direct Machine Expenses:		
(*a*) Depreciation—		
Cost	£2,000	
Estimated Scrap Value	400	
	£1,600	
Effective working life	12,000 hours	
Working hours per qtr.	360 ,,	
Depreciation per quarter $\frac{360}{12{,}000} \times$ £1,600 =		48 0 0
(*b*) Repairs, Maintenance and Oil—		
Total for effective life of 12,000 hours, £400		
Proportion for quarter of 360 hours		12 0 0
(*c*) Power—		
20 units per hour for 360 hours at 1d. per unit		30 0 0
		90 0 0
Indirect Factory Expenses attributable to Machine:		
(*a*) Supervision (equally to all machines)—		
One-sixth of one-half of £480 per year for 3 months		10 0 0
(*b*) Workshop Rent and Rates (by reference to space occupied)—		
One-quarter of £640 per year for 3 months		40 0 0
(*c*) Lighting and Heating (by reference to workers employed)—		
(Employed on 2 large machines, 3 each =	6	
,, ,, 4 small ,, 2 ,, =	8	
	14)	
Three-fourteenths of £182 per year for 3 months		9 15 0
Total costs attributable to one machine (excluding labour) for 360 working hours		£149 15 0

Machine-hour Rate $\frac{\text{£149 15s.}}{360}$ = 8s. 4d.

(The machine-hour rate for the small machines is calculated in a similar manner and is found to be 3s. 4d.)

Either of the two hourly-rate methods should give more accurate results than any of the three percentage methods but it must be recognized that they impose a much greater burden of detailed calculation. They

also depend, like all oncost rates calculated in advance of some of the expenditure actually being incurred, on two estimates, namely:

(1) The expenditure likely to be incurred.

(2) The labour-hours or machine-hours that will be worked (this estimate replacing the corresponding estimate of the value of production where a percentage method is used).

POST COSTING

Because of the wide margin of error that may be introduced when oncost rates are based on estimates of future costs and production, some authorities prefer to delay completion of the cost figures for a certain period so that the costs actually incurred in that period (whether direct or indirect) can be apportioned to the actual production. The cost accounts are then factual or historical like financial accounts and there can then, in theory at least, be no under- or over-recovery of costs. The method, which is generally known as post-costing to distinguish it from pre-costing based to a certain extent on estimates, is, however, open to the following objections:

(1) Unless the calculations are made at reasonably frequent intervals (say once a month) the figures when available will be largely out of date.

(2) Where, for seasonal or other reasons, the production is liable to fluctuate considerably as from one month to another, even though the total annual production may remain fairly constant, the monthly costs will vary substantially. Some of the costs (for example, factory lighting and heating) may also be subject to seasonal variation, which will be reflected in the costs if new calculations are made each month. An annual rate of oncost, calculated in advance, although it depends on estimates, does nevertheless ignore such seasonal variations and spreads the oncost evenly over the production of the whole year.

(3) Although total expenditure is allocated to total production of each period it does not necessarily follow that fair results are obtained as between different units of production completed in the same period. This, however, is largely a matter of selecting the correct basis of allocating the oncost (for example, as a percentage or as an hourly rate, according to the circumstances of the case).

(4) Much the same result can be obtained more easily if the costs, calculated by the more usual method of adding estimated rates of oncost, are ultimately compared in total with the results shown by the financial accounts, the amount by which there has been an under- or over-allocation of costs then being revealed.

DEPARTMENTALIZATION OF COSTS

A substantial gain in accuracy without any considerable increase in record keeping or calculation may often be achieved by dividing an undertaking into distinct departments, each of which is costed separately. In some cases departmentalization is essential. There are, for example, two distinct units of cost in the case of a railway, namely, the passenger-mile

for passenger traffic and the ton-mile for goods traffic. Many of the costs of operating the line are nevertheless common to both types of traffic; these costs must obviously be apportioned to the two departments of the railway before any useful calculation can be made.

As in departmental accounts, it is not necessary that there should be segregation of the various activities into different buildings or rooms. It is the expenditure that has to be apportioned to the various activities which are regarded as constituting separate departments. Where a physical separation is possible this apportionment is, of course, facilitated.

When oncost is to be dealt with in this way it is necessary:

(1) To estimate the total for the business as a whole (under the separate headings Works Expenses, Office and Administration Expenses and Selling Expenses respectively, where separate charges are to be made for each class of oncost).

(2) To decide how that total (or those totals) are to be apportioned between the various departments, having regard to the space occupied by each and any other relevant factors. (The calculation of a machine-hour rate in the example on page 517 illustrates the principles involved.)

(3) To express the amounts (or amount) apportioned to each department as a percentage or hourly rate on the estimated production of that department.

The rates of oncost thus calculated may, of course, show considerable variations in the different departments. For example, if in a goldsmiths' and silversmiths' business the costs are departmentalized for gold and silver production respectively, other things being equal the rate of oncost in the gold department will normally be lower than that in the silver department if it is expressed as a percentage on prime cost, because of the relatively higher material costs in the gold department.

These considerations are of greatest importance when dealing with factory oncost, which often works out at a substantial percentage on prime cost. Where office and general administrative expenses are comparatively low it is more usual to calculate one rate for the business as a whole. Selling oncost, on the other hand, if calculated separately is preferably departmentalized, as the costs of selling the output of different types of article may vary considerably.

PROCESS ACCOUNTS

Where the natural division of a business into its component parts reveals that the output of one department becomes, in whole or in part, the raw material of another department, the cost accounts are generally known as Process Accounts. The account for each process is generally comparatively simple, showing the total cost of the total production for a given period. As in single-cost systems, the cost per unit is then found by dividing the total production into the total cost.

If the output of one process is held in stock before it is drawn upon, as required, for the raw material of the next process it will be necessary to maintain stock accounts to link up the output of one process with the input of the next. Where, on the other hand, the operations are more or

less continuous, the output of one process can be taken to represent the input of the next. For the purpose of costing the second or subsequent process, this input can be valued by any of the following methods:

(1) At actual cost as disclosed by the process account for the process which produced it.

(2) At actual cost plus a percentage for profit in order to allocate to each process a reasonable proportion of the profits of the business as a whole.

(3) At the market value of the product in the state at which it passes from one process to the next, on the assumption that it could be bought in the open market at that price.

Methods (2) and (3) have the disadvantages of introducing an element of unrealized profit into the stock valuations if stocks are then held of either finished or partly processed goods. The resulting calculations necessary to eliminate this profit from the accounts can be very complicated. The first method is therefore to be recommended but the cumulative effects of the costs in the earlier processes upon those in the later ones must be noted.

Example

The following are simple process accounts for two successive processes, A and B, for two consecutive periods.

	Period 1	*Period* 2
Process A	£	£
Raw materials	500	600
Labour	1,000	1,400
Oncost (30 per cent on labour)	300	420
	1,800	2,420
Output (units)	10,000	12,100
Cost per unit	3s. 7¼d.	4s. 0d.
Process B	£	£
Input from Process A at cost	1,800	2,420
Other materials	300	204
Labour	500	600
Oncost (20 per cent on labour)	100	120
	£2,700	£3,344
Output (units)	9,000	11,000
Cost per unit	6s. 0d.	6s. 1d.

On comparing the results of Period 2 with those of Period 1 it is seen that the cost of the output of Process B has risen by 1d. per unit. The cost of the Process A output, however, actually rose by 4¾d. per unit, and as the whole of the Process A output is used in Process B it follows that the costs actually incurred in the second process fell. There is a further complication due to the fact that the number of

units emerging from Process B during each period was about 10 per cent less than the number of Process A units taken in. It may be inferred that there is some inevitable wastage or spoilage involved in the second process.

The Process B figures may, therefore, be interpreted in the following way:

	Period 1			*Period* 2		
		Amount £	*Per Unit of output*		*Amount* £	*Per Unit of output*
Input from Process A	(10,000 units)	1,800		(12,100 units)	2,420	
Wastage	(1,000 units)	180		(1,100 units)	220	
			s. d.			s. d.
Effectives	(9,000 units)	1,620	3 7¼	(11,000 units)	2,200	4 0
Other materials		300	8		204	4½
Labour		500	1 1¼		600	1 1
Oncost		100	2¾		120	2¾
Wastage		180	4¾		220	4¾
		£2,700	6s. 0d.		£3,344	6s. 1d.

RELATIONSHIP OF COST AND FINANCIAL ACCOUNTS

It has been shown that the cost accounts and the financial accounts from which the annual Profit and Loss Accounts and Balance Sheets are prepared serve entirely different functions. For that reason it is generally better that they should be kept in distinct sets of books. On the other hand, the cost accounts should allocate, in detail, most of the expenditure which is reflected in total in the annual accounts.

The two sets of figures should, therefore, be capable of reconciliation in total, and some attempt at reconciliation should always be made. This is particularly important where rates of oncost have been based on estimates of expenditure and production. Only by an annual comparison of the results shown by the cost accounts with the net profit disclosed in the Profit and Loss Account can the accuracy of the estimates be judged and any necessary amendments made for the ensuing period.

It should be noted that the comparison normally involves some process of reconciliation of the figures; exact or even approximate agreement is not to be expected, for the following reasons:

(1) Some items charged or credited in the financial accounts (for example, bank interest paid or dividends received from investments) will not normally have been taken into account for the purpose of calculating oncost rates.

(2) If the costing calculations are carried only to the cost-of-production stage, selling expenses will also reduce the annual net profit below the aggregate of the profits in the cost accounts.

(3) Stocks of finished goods and work-in-progress may be valued differently for the two purposes. This is particularly likely to arise in departmental or process accounts where transfers from one department or process to another are made at prices which exceed the true cost to the concern as a whole.

(4) Even if none of the foregoing factors is present, the difference between the estimated allocations of overheads as oncost and the expenditure actually disclosed by the Profit and Loss Account may be substantial.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) What is cost accounting and how does it differ from double-entry book-keeping?

(2) (*a*) Define "unit of cost."

(*b*) Suggest units of cost suitable for each of the following: (i) Road Transport; (ii) Sea Transport; (iii) Foundry; (iv) Hospital.

(*Chartered Accountants, Inter.*).

(3) What is the function of a Stores Ledger? Give a suitable ruling for a Store Ledger account kept in the loose-leaf form.

(*Chartered Accountants, Inter.*).

(4) In connexion with cost accounting, stores issued may be charged out at either (*a*) first in—first out value; (*b*) average cost; (*c*) current market price. Discuss the advantages and disadvantages of each basis and indicate any circumstances in which you consider it would be advisable to use one basis rather than either of the others. (*C.I.S. Inter.*).

(5) Certain articles, in course of manufacture, passed through two departments termed by the manufacturer K and B. During the month of June, 960 articles were manufactured, the expenditure being as follows:

	Dept. K	Dept. B
Direct Wages	£2,880	£2,160
Materials	£5,440	£720
Direct Expenses	£936	£900

The works oncost was 20 per cent on wages and the office oncost 10 per cent on the works cost.

Ignoring any question of work-in-progress and stocks in hand at the beginning and the end of the month, prepare statements showing the cost in each department and the total cost on which the manufacturer would have to base his selling price. (*A.C.C.A. Inter.*).

(6) From the following information compute a machine-hour rate of oncost in respect of Machine No. 546:

Cost	£550
Estimated scrap value	£34
Effective working life	10,000 hours
Repairs estimate over whole life of machine	£75
Standing charges of shop for four-weekly period	£85 10s.
Hours worked in four-weekly period	120
Number of machines in shop, each of which bears equal charges	30
Power used by each machine	6 units per hour costing 1d. per unit.

(*Chartered Accountants, Inter.*).

(7) A company manufactures two types of machine—hand-worked and electrically worked. The following are particulars of numbers manufactured and costs of manufacture during the year:

	Hand	*Electric*
Numbers manufactured	1,200	7,200
Factory Costs:	£	£
Materials	2,100	11,050
Wages	9,800	35,050
Factory oncost	1,800	8,700
	£13,700	£54,800

Other expenses not directly charged: Factory Supervision, etc., £2,900; Packing Department, £1,320; Selling, £3,250.

Factory Supervision, etc., is to be charged in proportion to the factory costs and the remaining expenses are to be treated as being the same for each type of machine, that is, that it costs the same to pack and sell either one hand or one electric machine. Prepare a statement showing the cost of each type of machine when ready for dispatch, and the price at which each machine should be sold to show a profit of 15 per cent. (*R.S.A. Stage III*).

(8) P & Co. is a small manufacturing firm. The following statement is a summary of the firm's trading results for the year to December 31:

		£
Sales		12,000
Prime cost of goods sold		9,300
		2,700
Oncost, selling and administration expenses varying in direct proportion to turnover	£ 900	
Fixed charges	1,200	
		2,100
Net Profit		£600

You are required:

(*a*) To express each heading of expense and the net profit as a percentage of sales.

(*b*) To calculate what would have to be the sales for the next year, assuming no change in the prime cost or selling price of the goods, in order that the net profit for the year should be £900.

(*c*) To ascertain what would be the effect on the net profit of an increase of 10 per cent on the selling price, assuming no change in the prime cost or in the oncost and selling expenses per unit sold, but that the result of the increase of selling price is a decrease of 20 per cent in the volume of sales. (*R.S.A. Stage III*).

CHAPTER XXI

ACCOUNTING MACHINES

Book-keeping by machines, or with the aid of machines, does not involve any radical departure from the principles of double entry. Machine accounting is not so much a new and modern type of book-keeping as a speeding-up and, in some cases, extension of the old form of handwritten record.

The design and manufacture of suitable machines has proceeded rapidly in comparatively recent years and has been fostered by the growth of large-scale commercial enterprises. In such concerns a capital expenditure of perhaps some thousands of pounds on the installation of machines is of small significance when compared with the resulting economy in the cost of office labour. It is not to be thought, however, that the main purpose of a machine is to displace office labour; rather it is to use it to greater advantage. The mechanization of routine processes of copying, adding and the like sets free the human brain and hand for tasks of greater responsibility and for using the records instead of merely making them.

Although the larger and more complicated machines will only be found in comparatively large offices where they can be kept fully employed, machines of less elaborate construction can be utilized in smaller concerns. Simple adding, or adding and listing machines, are not book-keeping machines in the strict sense but they can be of considerable assistance to the book-keeper. Any typewriter will take a number of carbon copies, but specially adapted typewriters designed to enable one copy to remain in the machine when others are withdrawn permits the principle of carbon copying to be extended to a number of book-keeping processes.

It is not proposed in this chapter to consider in detail the many specialized and often complicated machines that have been developed for particular purposes. The manufacturers make available extensive literature on this subject and will provide experts to advise on any particular problem. As between various makes of a machine designed for some particular purpose there may be some differences in detail, both in the way in which the operations are carried out and in the form of the final result. Those who are concerned with the installation of a machine system would therefore be well advised to explore the market thoroughly before coming to a decision.

Although a complete system of book-keeping may appear complex, the individual processes of which it is composed are comparatively simple. When machines are introduced these simple processes are carried out in a different way; sometimes, in a different order. It is therefore advisable to review the ordinary processes of book-keeping and to consider the mental and manual processes involved in a handwritten set of books, before proceeding to the subject of mechanization.

The normal processes of book-keeping, in the limited sense of writing up the books of account which constitute the double-entry system, can be summarized as follows:

(1) Writing up the books of prime entry by copying the relevant details from the appropriate documents, as follows:

Book of Prime Entry	*Source of Entry*
Sales Day Book	Copies of invoices sent to customers
Sales Returns Book	Copies of credit notes sent to customers
Purchases Day Book	Original invoices received from suppliers
Purchases Returns Book	Original credit notes received from suppliers
Cash Book—Debits	Cash (including cheques) received, from bank paying-in book and discount allowed from the statements accompanying the remittances, showing the amounts deducted, subject to the deduction first being checked. (The system may vary in different offices; for example, if receipts are sent out for all remittances received, the Cash Book (Dr.) may sometimes be written up from the copy (or counterfoil) receipts.)
Cash Book—Credits	Cheques drawn from counterfoils of cheque book. Discount deducted will generally be noted on the cheque-book counterfoil so that it can be entered in the Cash Book at the same time as the cheque.

(2) Posting the detailed entries made as in (1) to the appropriate accounts in the Personal (that is, Sales and Bought) Ledgers.

(3) Casting and balancing the Cash Book, subject to reconciliation with the Pass Book or Bank Statement.

(4) Balancing the accounts in the Personal Ledgers at suitable intervals (usually monthly) when all the postings for the preceding period have been made as in (2).

(5) Casting the books of prime entry (including Discount columns of Cash Book) and completing any necessary analysis (for example, columnar Purchases Day Book).

(6) Posting the totals of the Day Books, Return Books and Discount columns of the Cash Book to the appropriate ledger accounts.

(7) A Petty Cash Book will normally be kept by the person who is responsible for the custody and disbursement of the petty cash.

(8) A journal will be kept to record exceptional transactions; the use of it will not, therefore, usually be regarded as a routine process.

AUXILIARY PROCESSES

The following routine processes, although not in themselves part of the double-entry book-keeping system, are normally carried out by book-keepers.

(1) Preparation of invoices for goods sold to customers. This involves mathematical calculations in pricing various quantities and qualities of goods, in adding the items where more than one appears on the same invoice and in calculating and deducting trade discounts (as distinct from cash discounts) where appropriate. The preparation of the invoice itself involves writing, while the retention of a copy for reference and to provide the basis of an entry in the Sales Day Book involves copying.

(2) Preparing statements to be rendered to customers at regular intervals (usually monthly) to show the total amount owing by them. As those statements are copies of ledger accounts, writing and copying only are involved.

(3) Preparing receipts for monies received from customers in settlement of their accounts, again involving copying and writing.

(4) Checking invoices received from suppliers, involving the same mathematical processes as arise in the preparation of invoices but no writing or copying.

(5) Drawing cheques to be dispatched to suppliers after the statements received from them have been checked and passed for payment. This may involve the calculation of cash discount to be deducted. The preparation of the cheque involves writing and copying, and a copy (that is, counterfoil) of the cheque has to be retained to form the source of the Cash Book (Cr.) entries.

(6) Keeping records of employees' times of attendance and preparation of the weekly pay roll, including the calculation of P.A.Y.E. income tax and other deductions. Calculation, writing and copying are all involved.

Where there is no mechanization of accounts, each of these auxiliary processes and possibly many others, according to the nature of the business, must be completed before the corresponding stage of the book-keeping, in the strict sense, can be commenced. They may well account for much more of the book-keeper's time and effort than the book-keeping itself. It will be seen that mechanization enables some of them at least to be combined with one of the processes of book-keeping, two or three distinct operations then being carried out simultaneously. Even where this is not possible, suitable machines applied to a single operation (for example, calculations or additions) may greatly reduce its burden.

MENTAL AND MANUAL PROCESSES

The mental and manual processes involved in the foregoing summaries of routine book-keeping and its auxiliary processes may be classified as follows:

Selection. Knowledge of the way in which a given transaction has to be recorded, including the selection of the correct form or book in

which the record is to be made and, where a ledger is involved, choosing the correct account in which a posting is completed.

Writing. Making a permanent record on paper, either on a printed form (invoice, cheques, and so on) or in a book. Originally the book would have been a bound book, but this must now be extended to any arrangements of sheets of paper or cards which fulfils the same purpose.

Copying. A form of writing in which information already recorded in one form is reproduced in another form, this including the act of posting from a book of prime-entry to a ledger account.

Addition and Subtraction. None of the processes of book-keeping in the strict sense involve any higher form of mathematics than simple addition or subtraction. These are sometimes combined, as in the act of balancing an account.

Multiplication. Multiplication and the higher forms of mathematical calculation do not enter directly into double-entry book-keeping; they may, however, be involved in some of the auxiliary processes, such as invoicing and pay-roll preparation.

MACHINE PROCESSES—WRITING AND COPYING

The general function of book-keeping machines is to replace the corresponding mental or manual process in the following way:

Writing. By substitution of typescript for handwriting, generally resulting in greater legibility and, where the machine is operated by a comparatively competent person, greater speed. Some types of machine will "write" part of the record automatically; for example, the date, having been set up on the machine at the beginning of the day, will print automatically as each transaction is entered.

Copying. By suitable arrangements of carbon paper under the top copy or original record, or sometimes by a mechanical process which causes the machine to produce two distinct records of the information placed into it. Cut carbons and other devices make it possible to restrict the information given on some of the copies.

These functions of writing and copying can, of course, be carried out to a considerable degree upon any form of typewriter. Typewriters were so used long before mechanical book-keeping in the strict sense was considered possible. Typewriters which have been specially designed for book-keeping purposes, however, contain several novel features which considerably extend their utility. Of these, probably the most important, is the "double feed"—an arrangement of the platen (the rubber-covered roller round which the papers revolve and which forms the backing for them at the moment when they receive the impression of the type bars) which enables one or more of the copies to remain securely in the machine while others are withdrawn. One of the "copies" may thus be an accumulation of the entries on a large number of separate documents or accounts.

ADDING MACHINES

Most adding mechanisms work on the mileometer principle, the depression of keys corresponding to the number to be added, causing the mechanisms to rotate in the various positions for units, tens, and so

on, the appropriate number of times. The rotations accumulate as each new number is added, until the mechanism is cleared in order to commence a new operation.

In countries where the pound is the monetary unit, adding machines which are to be used in conjunction with or as a part of a book-keeping system are so constructed that they add in pounds, shillings and pence (and possibly farthings also) directly. This merely means that the pence column does not carry over into the shillings column until it has reached the total twelve, while the ten-shillings column carries over into the pounds (units) column at every other rotation (that is, it will record only 0 or 1).

An adding machine, in the limited sense, merely shows its results as a row of figures seen through small openings in the machine (like the mileage record on the dashboard of a motor-car). If the total is required for a book-keeping process it then has to be copied from the machine. Such a machine, to be of the greatest utility, is generally of the full-keyboard type and may be used (by the process of repeated addition or subtraction) for calculating work of a higher order. It is not strictly a book-keeping machine, but it may be of assistance to a book-keeper.

ADDING AND LISTING MACHINES

In adding and listing machines the keyboard and the adding mechanism are connected mechanically to a series of type bars so that:

(1) Depression of the keys appropriate to a number or amount that is to be added causes that number or amount to be typed on paper. The machine has a small platen, like that of a typewriter, and, if necessary, papers of varying size (but generally of comparatively narrow width) can be inserted in the machine at the commencement of each operation. For general purposes, however, the machine is provided with a large roll on which an almost endless list of figures (subject to the adding capacity of the machine) can be accumulated. The used part of the roll is then torn off at the end of the run of additions. Some machines have no platen in the ordinary sense and can produce only a "machined list" on the standard roll of paper.

The typing of the figures is not direct, as in the case of a typewriter, but proceeds in two stages:

(*a*) The depression of the keys sets up the required amount in the machine.

(*b*) The depression of an "add" or "motor bar" in the case of an electrically operated machine, or the pulling of a handle in others, has the double effect of typing the amount and of operating the adding mechanisms.

(2) Depression of a "sub-total key" will cause the existing total of the adding mechanism to print on the roll of paper, with a suitable sign indicating that it is a sub-total but without clearing this total from the machine.

(3) Depression of a "total" key will cause the existing total to be printed and the machine to clear, ready to start a new series of operations. (Operators are trained to *commence* a new operation by depressing

the "total" key; this will have the effect of clearing any figures that were left in the machine as a result of the previous operation not being completed.)

Example

To add £1 6s. 7d. and £9 18s. 3d. show a sub-total and add £5 4s. 9d. To obtain the final result, the operation (on a full-keyboard, electrically operated machine) will be:

(1) Depress "total" key.
(2) Depress keys 1 (pounds) 6 (shillings) 7 (pence).
(3) Depress "add" key.
(4) Depress keys 9 (pounds) 1 (ten shillings) 8 (shillings) 3 (pence).
(5) Depress "add" key.
(6) Depress "sub-total" key.
(7) Depress keys 5 (pounds) 4 (shillings) 9 (pence).
(8) Depress "add" key.
(9) Depress "total" key.

And the result will appear as follows:

```
       *
 1  6  7
 9 18  3

11  4 10 S
 5  4  9

16  9  7 *
```

There are many different makes of adding and listing machines, but for most purposes they fall into two groups—"full keyboard" and "twelve-figure keyboard" machines. A full keyboard has a column of figure keys in each position (pence, shillings, units of pounds, tens of pounds and so on) within the capacity of the machine. These keys can be represented diagrammatically in the following way:

9	9	9	9	9	9	9	9	1	9	9	11
8	8	8	8	8	8	8	8	1	8	8	10
7	7	7	7	7	7	7	7	1	7	7	
6	6	6	6	6	6	6	6	1	6	6	
5	5	5	5	5	5	5	5	1	5	5	
4	4	4	4	4	4	4	4	1	4	4	
3	3	3	3	3	3	3	3	1	3	3	
2	2	2	2	2	2	2	2	1	2	2	
1	1	1	1	1	1	1	1	1	1	1	

The keys illustrated are those which actually set up amounts in the machine when they are depressed. Others, which give effect to the operations Add, Subtract, Sub-total and the like, are provided as may be necessary according to the purposes for which the machine is to be used. The number of vertical columns of number keys varies according to the capacity of the machine. The diagram illustrates the keyboard of a comparatively large machine which can cope with amounts up to £99,999,999 19s. 11d.

The repetition of the 1 key in the 10s. column should be noted; this is of assistance in fingering. It will be observed also that no cipher keys (0) appear on this keyboard. Every column records 0 unless and until one of the 9 digit keys in it is depressed.

A twelve-figure keyboard, on the other hand, has only one key for each digit from 1 to 11 and one cipher key 0. It may be represented diagrammatically as follows:

10	11	
7	8	9
4	5	6
1	2	3
	0	

The provision of the 10 and 11 keys indicates that the machine is intended to record £ s. d. In the United States (or other countries where a decimal coinage is used), where these machines were first produced, the highest digit required is 9; the keyboard is therefore sometimes referred to as a ten-figure one. In addition to the number keys the appropriate operational keys are provided.

The operation of a machine of the full keyboard type has been explained in relation to the example given on the preceding page. Had a twelve-figure keyboard been used, the operations would differ only in the setting up of the amounts. The appropriate keys have to be depressed in the proper order: to set up £1 6s. 7d. this order is 1, 0, 6, 7. The cipher key 0 has to be used because the number of shillings is below ten; otherwise the machine will record the amount as 16s. 7d. The cipher key also has to be used wherever there is a 0 in the figure to be added. Thus, whereas to set up £10,000 0s. 0d. on a full keyboard machine would require the depression of only one key—the unit key in the column "ten thousand pounds"—on a twelve-figure keyboard it will be necessary to depress the 1 key followed by *seven* consecutive depressions of the 0 key (6 times for the noughts that appear in the figure as printed and another because the number of shillings is less than ten).

BOOK-KEEPING MACHINES

As most book-keeping operations have been seen to be composed mainly of operations involving writing, copying and adding (or subtracting), a book-keeping machine is essentially one which combines the

writing and copying facilities of the typewriter with the adding mechanism of an adding machine. Such machines have been developed primarily for the purpose of posting ledger accounts but many are found to be available for other purposes, such as cheque and receipt writing. These operations are considered in greater detail hereafter.

SELECTION

The selection of, say, the correct ledger account in which to make an entry still rests upon the operator and not upon the machine itself. As mechanical systems require the ledgers to be in card or loose-leaf form, however, they have led to the introduction of specialized ledger trays or binders, which greatly facilitate the task of picking out individual accounts. It is also possible to incorporate in the posting system a routine which will help to reveal to the operator the fact that the wrong account has been selected; this does not prevent a wrong selection being made but it does help to detect (and, therefore, correct) such errors if they are made.

CALCULATION

As calculations other than addition and subtraction do not normally enter into such book-keeping processes as ledger posting, calculating machines have tended to develop independently of book-keeping machines, and for different purposes. It would, therefore, be outside the scope of this chapter to consider them in detail, but it may be noted that they fall into two main classes, of which the first, being in form an adding machine, can also be used as an aid to book-keeping:

(1) Adding machines adapted for rapid operation so that multiplication and division can be performed by successive addition or subtraction respectively.

(2) Calculating machines of the "barrel" type, in which the rotation of a crank (either electrically or by hand) produces the repeated additions or subtractions which are implied in the processes of multiplication and division.

LEDGER-POSTING MACHINES

The commonest application of the book-keeping machine, as such, is found in the posting of the Sales Ledger, which, in most concerns in a trade entailing the granting of credit, probably accounts for more than half of all the book-keeping entries that have to be made. Most of these postings fall into one of three groups—invoices, credit notes, and cash and discount—but there will be exceptional entries from time to time originating in the journal (for example, bad debts written off). Of these groups, debit postings of invoices will normally be the largest; in an active account there may be one or more invoices for goods sold to that customer every day. Sales Ledger accounts normally show debit balances which are thus increased by the posting of debit items. The main function of a book-keeping machine as applied to Sales Ledger postings is therefore:

(1) To record in the correct accounts the debit entries for goods sold to each customer.

(2) To add the amounts thus recorded to the existing balance in order to ascertain the new balance, which is then recorded on the face of the account.

Before the amount that is being posted can be added to the existing balance, the latter has to be "picked up." This introduces a book-keeping step which is not present when ledgers are posted by hand. As the adding mechanism is linked to the typewriting mechanism, the figures that are picked up by the operator must normally be reproduced on the ledger card, which therefore must contain two balance columns. The following ruling may, therefore, be appropriate:

Customer's Name H. Smith & Co., Ltd. *Account No.* 129
Address 101, High Street, N.E.10

Old Balance	*Date*	*Description*	*Ref.*	*Debits*	*Credits*	*New Balance*
	JAN. 7	GDS	1091	10 6 3		10 6 3
10 6 3	JAN. 10	GDS	1172	21 9 8		31 15 11

If a carbon copy of each account is taken in order to serve as a monthly statement, it will be unnecessary, and in some respects undesirable, to have two balance columns on the statement. As the statement copy is usually on thin or ordinary paper whereas the ledger account is stiff paper or card, the ledger is usually the carbon copy of the statement. The statement is, however, somewhat narrower than the ledger so that the old balance figure is recorded on the ledger only. The entries shown in the ledger account above will then appear as follows on the statement:

STATEMENT

H. Smith & Co., Ltd., *Ref.* 129
101, High Street, N.E.10

Dr. to THE MODERN Co., Ltd.,
10, London Road,
WESTCHESTER.

Date	*Description*	*Balance brought forward*			£ s. d.
		Ref.	*Debits*	*Credits*	
			£ s. d.	£ s. d.	
JAN. 7	GDS	1091	10 6 3		10 6 3
JAN. 10	GDS	1172	21 9 8		31 15 11

A new statement has to be commenced each month. Where, as in the illustration, the Old Balance column does not show on the statement, the balance brought forward at the beginning of the month has to be typed in on an ordinary typewriter. The ledger card is, of course, continued in use from one month to the next until it has become filled, when a new one will be started. Used cards must generally remain available for reference for a reasonable time, in separate trays or cabinets.

The "active" account cards are arranged in a tray or trays to which the operator has easy access. As postings are made on the slip system, either from the original document (or a carbon copy of it, as in the case of sales invoices) or from a posting slip containing particulars of the transaction, these documents are usually inserted into the tray of cards, each one being placed in front of the appropriate account card. After each posting has been completed the ledger card is returned to the tray but is staggered (that is, placed somewhat out of alignment) so that, if needed, these cards can be withdrawn again for checking.

The direct posting from copy invoices eliminates one stage of ordinary book-keeping—the writing up of a Sales Day Book from which the ledger is subsequently posted. A further carbon copy of each posting is, however, retained on a Control Sheet in the machine. The special construction of the platen of the machine enables this sheet to remain in place as each ledger card is withdrawn; the spacing up of the control sheet to take a copy of the next posting is usually performed automatically, as also is the "carriage return" to the position in which the next entry will have to commence (normally the old balance column). This Control Sheet then records all the postings in a given batch and thus takes the place of the ordinary Sales Day Book. It provides totals from which the Sales Account and the Sales Ledger Control Account are written up.

The adding mechanism which adds the amount that is being posted on to the amount of the existing balance is known as a "cross-footer" because it adds (or subtracts) figures which are being recorded on the same horizontal line. At the conclusion of each posting (that is, when the new balance has been recorded) the cross-footer clears, ready to start on the next posting.

In addition to the cross-footer, one or more registers may be provided for accumulating totals of all the figures in all or some columns of the record. Thus, before the amount of an invoice can be recorded, the carriage of the machine has to move to the column headed Debits. In this position (and in no other) all the figures typed are automatically added into one of the registers. At the end of the batch of postings this register will then show the total of all the invoices in the batch and will record this total on the Control Sheet. Without this mechanism it would be necessary to add up each Control Sheet after withdrawing it.

PRE-LISTING

Since the human element is not entirely eliminated by machine operation, it is necessary to introduce certain checks into the routine which enable the accuracy of the work to be established. Of these, perhaps the commonest and most important is the practice of pre-listing.

It has been seen that sales invoices are posted directly from the copy invoices. If the operator copies an amount incorrectly, the same wrong amount will automatically appear both in the "Day Book" (that is, the Control Sheet) and the Ledger. The books will, therefore, appear to balance but the balance shown on the account concerned will, in fact, be wrong.

If the invoices are pre-listed before they are handed to the machine operator, it will be possible to compare the total of the pre-list with the total of the Control Sheet. Unless a compensating error has occurred or the same mistake has been made in pre-listing as in posting, any error in posting should be apparent. When the two totals disagree it is generally a comparatively easy task to check the amounts on the pre-list with those on the Control Sheet; the account concerned in the error is thus located.

Where sales invoices are concerned the system is strengthened by pre-listing the original invoices as distinct from the carbon copies which form the posting medium. Any error due to a faulty carbon is then revealed. Where this is not possible (perhaps because invoices are dispatched from several different departments before the copies are centralized for posting purposes) the pre-list should in any case be prepared by someone other than the machine operator. The material which is to be pre-listed should, if possible, be arranged in the order in which the postings will be effected (usually either the alphabetical or numerical order of the ledger accounts). This facilitates comparison of the two lists of amounts (Pre-list and Control Sheet) when an error does arise and has to be traced.

BALANCE PROOFS

The process of pre-listing the copy invoices or other posting media may establish the accuracy of the amounts posted on to a batch of ledger cards, but that is only one step in proving that the new balances are correct. If the operator makes a mistake in the pick-up of the existing balance there will be a corresponding error in the amount of the new balance calculated and recorded by the machine. Once more the use of a machine cannot in itself prevent the mistake but the system can be so designed that the error will be detected.

The methods vary according to the nature of the machine involved but mostly depend on a double pick-up. Care must be taken that the operator, when picking up the old balance for the second time, refers to the original figure brought forward on the ledger sheet; the other may be recorded on the Control Sheet or, alternatively, it may be a non-print operation in which the amount is added into the appropriate cross-footer or a register of the machine without operating the type-bars.

CONTROL ACCOUNT

Ledgers posted on a machine are always subject to an overall check in the form of a Control Account, which records in total the figures posted in detail in the course of each run or batch of postings. The principles involved are precisely similar to those considered in relation to self-balancing ledgers (see Chapter XV). At least once a year the individual balances on the Sales Ledger accounts will have to be properly scheduled for audit purposes and to establish the total of Sundry Debtors

which will be required for the Balance Sheet. An arithmetical check on the Sales Ledger can be obtained at much shorter intervals (say at least once a month) by running out the balances (without names or other details) on an adding machine and comparing the total with the balance of the Control Account.

Where the number of active accounts is not too large and each batch of postings affects a substantial proportion of the accounts, it may be possible to check the total of a list of new balances against the Control Account balance after each run of postings. It must be emphasized, however, that the total of the New Balance column of the Control Sheet cannot be used for this purpose unless *every* account in the ledger has received a posting in that batch, which is unlikely. Nevertheless, the extra time and trouble involved in running out the balances on an adding machine (the book-keeping machine itself can be used, if it is not required for other work) is usually justified by the greater check that is obtained. Incidentally, such a procedure will make a double pick-up check unnecessary, as an error in picking up a balance would be revealed by disagreement of the Control Account. There is the further point that if the detailed balances do not agree in total with the Control Account balance, the labour involved in finding the difference is proportionate to the time that has elapsed since the ledger was last proved.

A ledger that involves a large number of accounts should be split up into convenient sections for balancing purposes. In particular, where several machines and operators are necessary to cope with the work, each should balance independently of the others. It may be noted that where any ledger is balanced in sections, the transfer of an account from one section to another must be reflected by a corresponding transfer between the two Control Accounts that are involved. For this reason it is generally advisable to open a new card and to transfer the balance from the old one by journal entry.

DOUBLE RUN

Pre-listing, pick-up proofs and Control Accounts are all subject to one limitation; they do not prove that entries have been made in the proper accounts. Where it is of the utmost importance that such an error should not occur or, if it does happen, will be detected almost immediately, as for example in bank book-keeping, the double-run process is helpful. In such cases statements are not carbon copies of ledger accounts (or vice versa), but are built up by a second operator posting them directly to the statement (that is, pass-book sheet in the case of a bank) from the same original documents.

Subject only to the possibility of compensating errors or of the two operators both making the same mistake, a comparison of the new balances shown by the ledger account and the statement respectively proves that:

(1) Postings have been made to the correct accounts.

(2) The old balance was picked up correctly.

(3) The correct amount was posted.

The double-run method does not necessarily double the time that is taken when statements and ledger accounts are posted as one operation. It may, for example, be possible to dispense with the pick-up check that otherwise increases the time taken by the single posting operations. Time is saved also because the statement and ledger sheets do not have to be carefully aligned (and carbon paper inserted) before they are inserted together in the machine. The independent actions of the two operators when the double-run method is used also form a valuable part of the system of internal check.

Although double-run checks the accuracy of the accounts posted it is still advisable to pre-list the copy invoices or other posting media, to make sure that none has been mislaid.

ACCOUNT NAMES OR NUMBERS

A Control Sheet resulting from the posting of a batch of sales invoices has been seen to fulfil the function of a Sales Day Book in that it is a record of all invoices posted and gives the requisite totals for completing the double entry in Sales Account. It is, however, open to the objection that it does not record the name of the account to which each posting is made. By giving each account a number, which serves not only as a ledger folio but also as a reference that is used in all dealings with the account and appears on all invoices, receipts and other posting media, and by recording the number as part of each entry, the following advantages are obtained.

(1) The account number appears on the Control Sheet and thus identifies each entry with the account to which it relates.

(2) The repetition of the number on the face of the ledger account, as successive postings are made, helps to reveal a posting to the wrong account, as a "wrong number" shows up in a column in which all the numbers ought to be the same. If this check is to be relied upon, however, the operator must be trained to copy the account number from the posting medium and not from the top of the ledger card.

CREDIT POSTINGS

Although the principles of ledger posting by machine have been considered so far mainly in relation to the posting of sales invoices, which normally provide the greatest volume of work, these principles can be extended without difficulty to cover the posting of credit notes, cash received and discounts allowed to the credit side of a Sales Ledger Account.

So far as the adding mechanism is concerned, a credit posting is, of course, a negative debit posting. The posting to a Sales Ledger account of a credit for, say, cash received, therefore normally involves the picking up of an existing (debit) balance, subtracting from it the amount now posted in the credit column of the ledger and recording the difference as a new balance. The same checks in regard to old balance pick-up, account number, and so on, are necessary, but pre-listing may be dispensed with where the batch of entries concerned has already been recorded and totalled for some other purpose (for example, mechanized Cash Book).

If the same machine is to be used for Bought Ledger work as for Sales Ledger posting, it will generally be found that the debit and credit columns on the Bought Ledger accounts are transposed. This is because, for Sales Ledger work, the machine is set to add to the old (debit) balance any amount recorded in the debit column and to subtract from it any credit posting.

The existing balance on a Bought Ledger account is normally a credit balance to which credit postings (that is, invoices received from suppliers) have to be added and from which debit postings (for "credit" notes received, cash (cheques) paid and discount received) must be deducted. Thus, to avoid altering the set-up of the machine every time it changes from the one ledger to the other, the credit postings to the Bought Ledger appear in what would normally be regarded as the debit column.

Bought Ledger cards and Sales Ledger cards should be separately printed and of different colours, to avoid confusion. The spacing of the columns must, of course, be identical if the same set-up of the machine is to be used. The following ruling is similar to that shown on page 533 for a Sales Ledger account, except that an additional column for account number has been introduced as suggested on page 537.

Supplier's Name Jones Brothers — BOUGHT
Address 202, London Road, S.9. — *Account No.* 321

Old Balance	*Date*	*Account No.*	*Description*	*Ref.*	*Credits*	*Debits*	*Balance*
	Jan. 1	321	BLCE		97 2 8		97 2 8
97 2 8	3	321	GDS	1049	21 10 0		118 12 8
118 12 8	5	321	GDS	1082	8 6 9		126 19 5
126 19 5	6	321	CSH	629		97 2 8	29 16 9
29 16 9	8	321	GDS	1121	9 2 1		38 18 10
38 18 10	8	321	RTN	93		8 6 9	30 12 1

(The cut corner of the card is of assistance in filing correctly; any card that has been filed the wrong way round, or upside down, is revealed at a glance.)

If the Sales Ledger routine includes the taking of a carbon-copy statement, the same arrangement of forms in the machine will enable a Remittance Advice to be prepared. This is a carbon copy of the Bought Ledger account to which it relates; it is sent to the supplier with a cheque for the balance shown to be due to him at the end of the month. The use of such advices is normally restricted to cases where suppliers' accounts are paid regularly once a month; they may be of great assistance in

reducing the number of queries that would otherwise have to be dealt with by correspondence.

The postings relating to Goods and Returns are normally made from the original invoices and credit notes received from suppliers. The Control Sheets then save the purpose of Purchases Day Book and Returns Outwards Book respectively. In cases where an analysed Day Book would be used because the invoices received and recorded in the Bought Ledger do not all relate to "purchases" in the strict sense, two alternatives are open:

(1) If the machine has a sufficiently large carriage to take a very wide Control Sheet and a sufficient number of registers in which to accumulate a number of different totals, the analysis can be extended on to the Control Sheet as part of the original entry.

(2) The invoices that have been posted in the ordinary way can be re-sorted according to the various classifications (which should, in any case, be settled and marked clearly on each invoice before it is passed for posting) and the accounts falling into each category run off on an adding machine. The various totals (one for each analysis group obtained in this way) will then be listed, totalled and agreed with the total or totals of the corresponding Control Sheets.

The routine for cash (cheque) payments will depend upon the system in force for cheque writing. Where the cheque writing has been mechanized, posting slips will be available and the mechanically prepared Cash Book will act as a pre-list. In other cases where cheques are either written by hand or a cheque writing machine which does not produce a carbon-copy Cash Book is used, it will be necessary to pre-list the cheques before they are posted.

It may be noted that mechanically prepared ledger accounts do not require any entries at balancing times, as do handwritten ledgers, because the accounts are automatically balanced in the posting process.

JOURNAL ENTRIES

All entries in Bought or Sales Ledger accounts which do not fall into the category of Goods (purchases or sales), Returns (outwards or inwards), Cash (paid or received) and Discount (received or allowed) can be made the subject of journal entries. These will include transfers from one account to another to correct errors or to give effect to contras, bad debts written off, interest on overdue accounts (where applicable) and any other exceptional entry.

Every journal entry involves at least two postings (at least one debit item and at least one credit item) which may affect the General Ledger (including the Nominal or Private Ledger) as well as one or other of the Personal Ledgers. It is, therefore, usual to find that journal entries are first written by hand in an ordinary bound journal, postings to those ledgers which have not been mechanized are made in the ordinary way, and a posting slip is prepared when one or both sides of the entry affect the Bought or Sales Ledgers. The posting slip is passed to the appropriate machine operator, who effects the posting. The corresponding entry in

the Control Account for the ledger concerned must not be overlooked; if several journal entries are posted at the same time the Control Account posting can be made from the total of the Control Sheet.

MECHANIZED CASH BOOKS

Any collating-carriage kind of typewriter can be used, in conjunction with suitably printed forms, for writing receipts and cheques and preparing, at the same time, carbon-copy Control Sheets which serve as a detailed record of the bank transactions. It is then unnecessary to recopy all these details into a bound Cash Book; the totals of cash received and cash paid respectively and of the appropriate discounts can be transferred daily or at other convenient intervals into a General Cash Book.

If a ledger-posting machine is used for this purpose, the adding registers of the machine can be set to record the totals of each batch of entries.

Carbon copies of the individual items on each list can also be made, to serve as posting media for postings to the Bought and Sales Ledgers. It may be advisable to exclude from the machine operation items which will not result in a posting to the personal ledgers; these will then be entered by hand in the General Cash Book.

RECEIPTS

The first essential of a combined receipt-writing, cash-book-writing operation is that all the words and accounts that have to be typed should come, as far as possible, on one line. This does not apply to the standard wording that is already printed on the form or to the signature that is made on it subsequently and not reproduced in the Cash Book.

The "one line of typing" condition necessarily gives rise to a receipt form which is comparatively wide but shallow. It would, therefore, be difficult to insert separate forms in the machine, one after the other, so they are usually printed in continuous or fan-fold form, perforated so that each one can be torn off as it is completed. The carbon copy which serves as a posting slip is perforated horizontally at similar intervals so that each slip is torn off with the relevant receipt. For this reason the receipt forms are usually smeared on the back with carbon, to avoid the use of separate carbon paper.

An ordinary typewriter could be used, but the entries on the Control Sheet (that is, Cash Received sheet) would then be spaced out at distances equal to the width of the receipt forms. The use of a collating-carriage type of machine makes the movement of the Control Sheet independent of that of the receipt forms and posting copies. The Control sheet then moves up one space only before each new receipt is typed, so that the entries on it are in fact in single spacing.

The minimum amount of information that must be typed on the receipt is: (1) Date; (2) Customer's name; (3) Amount.

In the form illustrated on page 541, therefore, the width of the receipt has been kept to a minimum by restricting the typed entry to those three items. Other information which is necessary to preserve a full record in the Cash Book (including the number of the receipt issued) and to complete the posting in the Sales Ledger then appears on the posting slip

CASH RECEIVED					
Ac. No.	*Receipt No.*	*Date*	*Name*	*Amount*	*Discount*
S.21	000001	6 JAN. 48	H. Smith & Co.	97 10 0	2 10 0
J.108	000002	6 JAN. 48	W. Jones, Ltd.	3 6 8	
R.19	000003	6 JAN. 48	Robinson & Sons	58 4 0	1 16 0
W.2	000004	6 JAN. 48	Wilkins & Slater	12 9 11	
X.1	000005	6 JAN. 48	The X Manufacturing Co.	135 16 0	4 4 0
H.6	000009	6 JAN. 48	Harper Bros.	33 19 0	1 1 0

(*see note* 1 *below*)

W.32	000017	Received from: The sum of £ s. d. 6 JAN. 48 W. Webster 195 0 0 Cheque With thanks Cash for **The Modern Co., Ltd.** P.O. 000017 .... Cashier 2d. Stamp	5 0 0
		Received from: The sum of £ s. d. Cheque With thanks Cash for **The Modern Co., Ltd.** P.O. 000018 .... Cashier 2d. Stamp	

Notes. (1) This section of the posting slip would normally be removed at the same time as the receipt to which it relates. It has been retained here for the purpose of illustration.

(2) If continuous forms are used for the receipts and posting slips it is not necessary to remove them from the machine until the whole batch has been completed.

and Cash Received Sheet only; these in consequence are wider than the receipt itself. If it is desired to record the discount on the receipt form the latter will be widened accordingly.

CHEQUES

The extension of the mechanical process to cheque writing involves no new principle, if receipts are already being dealt with in that way. Arrangements must be made with the bank concerned to have special forms printed; these again will usually be in continuous form. A somewhat wider set-up will be necessary, as the bank will require the amount of each cheque to be recorded in words as well as in figures. For this reason, and particularly where large amounts may be involved, it may be necessary to devote two lines, instead of one, to each entry. The form will, in any case, be deeper than the receipt form, as the name (and clearing references) of the bank must appear on it and there must be adequate room for the necessary signatures.

The cheques will not necessarily be drawn, signed and dispatched all on the same day, so the date is usually added by means of a rubber stamp after the cheque has been prepared and does not constitute part of the entry. The same date must be inserted on the posting slips and at the head of the Cash Book Sheet.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) To justify mechanization certain conditions must exist. What do you consider these to be? (*Inst. of Bkprs., Inter.*).

(2) Apart from any considerations of individual machines or their features, outline some of the factors which you consider influence machine output. (*Inst. of Bkprs., Fellow*).

(3) Describe concisely the kind of work for which each of the following types of office machine is suitable, and mention the advantages and disadvantages of each type of machine for the kind of work concerned:
(*a*) Adding-listing machines.
(*b*) Key-driven, non-listing, calculating machines.
(*c*) Crank-operated calculating machines. (*Chartered Accountants, Final*).

(4) When deciding upon the type of filing equipment to purchase for filing your Sales Ledger cards, what factors would you take into consideration? (*Inst. of Bkprs., Associate*).

(5) The accountant of a manufacturing company wishes to mechanize the accounts department, where at present all the books are written up by hand. The cost of the requisite equipment will be considerable and the directors have asked him to prepare a report justifying this expenditure.
State four points which you consider should be dealt with in this report, giving your reasons. (*Chartered Accountants, Final*).

(6) Compare the functions, if any, of a Day Book in a mechanized system with that of a pen-and-ink system. (*Inst. of Bkprs., Fellow*).

(7) A client, who owns a manufacturing business with 2,000–3,000 active customers' accounts, seeks your advice as to the relative features of:
(*a*) mechanized (not punched card) Sales Ledgers, and
(*b*) handwritten Sales Ledgers.
You are required to set out in tabular form a comparative statement of the relative features of the two systems. (*Chartered Accountants, Final*).

(8) Over a number of years a concern has successfully mechanized its Sales and Purchase Ledger work as well as Wages, Cheque writing, Analysis, etc. If you were asked to report on the possibility of mechanizing the Nominal Ledger, what points would you cover? (*Inst. of Bkprs., Fellow*).

(9) What is the object of a balance proof? Give an example of such a proof, and state the types of error it is designed to reveal. (*Inst. of Bkprs., Associate*).

(10) State which of the following three balance proofs you prefer and give reasons:
(*a*) Mechanical comparison, line by line, of the first amount brought forward with a second pick-up and their mutual cancellation (if identical) resulting in the printing of a zero or "clear" symbol.
(*b*) An accumulation of all postings, all new balances and all second pick-ups so that upon the completion of the work a comparison of total new balances with postings plus pick-ups should show agreement if the work has been done correctly.
(*c*) The accumulation of all pick-ups and their agreement in total with an independent list of the old balances on all active accounts either before or after posting. (*Inst. of Bkprs., Fellow*).

CHAPTER XXII

INSOLVENCY AND LIQUIDATION

THE expression bankruptcy is commonly, and often incorrectly, used to indicate a state of affairs in which a person is unable to meet his debts. This condition is more correctly known as insolvency; in some cases it results in bankruptcy proceedings, but in others the debtor is able to stave off financial disaster by raising loans or by coming to some arrangement with his creditors.

Where bankruptcy, in the strict legal sense, does ensue, the proceedings are governed by the Bankruptcy Acts, 1914 and 1926, and the Bankruptcy Rules made pursuant to those Acts. Bankruptcy procedure is designed to serve two main purposes:

(1) To secure (under proper supervision) that all the property owned by the bankrupt is divided fairly and rateably among all his creditors, having regard to the securities which some of them may hold and certain preferential claims as laid down in the Acts.

(2) To relieve the bankrupt from the burden of his existing liabilities, so that he may make a fresh start (in the financial sense).

To serve these two ends it is provided that the petition which leads up to the bankruptcy can be presented either by a creditor or by the debtor himself. In the latter case he is said to "file his petition" and many bankruptcies do commence in this way, since creditors are often unwilling to throw good money after bad in the expense of instituting the proceedings themselves.

Until the competent Court has made an Adjudication Order in bankruptcy the debtor is not, technically, a bankrupt and he should not be referred to as such. The proper expression at this stage is "debtor"—one from whom money is due. Once the order has been made, however, the proceedings follow the same course whether the petition was presented by the debtor himself or by a creditor. The debtor is now a bankrupt and remains so until he obtains his discharge. In the meanwhile, he is an undischarged bankrupt and as such is subject to certain civil disabilities. He may not, for example, act as a director of a limited company without leave of the Court.

Bankruptcy proceedings apply only to individuals, including partners. The debts which give rise to a bankruptcy need not be connected with the carrying on of a business and, except where a partnership is concerned, no distinction is made between business assets and liabilities, and private assets and liabilities respectively.

Companies, not being individuals or partnerships, are not subject to bankruptcy procedure; they are "wound up" by being put into liquidation.

Any person who is in a position to enter into a valid contract in this country and is therefore subject to the jurisdiction of the Civil Courts is liable to be made bankrupt if his debts exceed £50 and he has committed

an "act of bankruptcy." Married women are now fully liable to bankruptcy proceedings and not, as was formerly the case, only in respect of liabilities arising from the carrying on of a business. A person who is under 21 years of age (legally an infant) cannot be made bankrupt. Foreigners may be liable to bankruptcy proceedings in respect of liabilities incurred in this country.

In London the control of bankruptcy proceedings is vested in the High Court of Justice; in the provinces most of the County Courts have jurisdiction in bankruptcy. The petition should be presented in the Court for the district in which the debtor has carried on business or resided longest during the preceding six months; if his address is unknown the petition is presented in the High Court.

Governmental control of bankruptcy matters is exercised by a department of the Board of Trade. The senior official in each bankruptcy district is known as the Official Receiver, who is also an officer of the Court for the purpose of administering the Act.

BANKRUPTCY PETITION

A bankruptcy petition presented by a creditor must be founded upon an act of bankruptcy, otherwise the proceedings might be abused by the presentation of petitions against perfectly respectable and solvent traders, whose credit might suffer irreparable damage.

There are eight acts of bankruptcy specified in the Act, upon any one of which a petition can be founded. They can be summarized as follows:

(1) An assignment of the debtor's property to a trustee for the benefit of his creditors generally.

(2) A fraudulent conveyance, gift or transfer of any of the debtor's property.

(3) A conveyance or transfer of property which amounts to a "fraudulent preference."

(4) An attempt to defeat or delay creditors by going abroad or remaining abroad, leaving his dwelling house, "keeping house," and so on (in other words, evading his creditors).

(5) The levying of execution (that is, distraint upon his goods and chattels in respect of a judgment given against him in an action for debt), provided the goods have either been sold or held by the sheriff for 21 days.

(6) The filing by the debtor himself of a declaration of his inability to pay his debts, or the presentation of a petition by the debtor.

(7) Non-compliance with a Bankruptcy Notice served upon him by a judgment creditor. (This is the normal procedure by which a creditor for a substantial sum institutes bankruptcy proceedings. Having obtained final judgment for his debt, he could proceed to levy execution, but this will not help him if there are not likely to be goods and chattels available to that amount. Bankruptcy proceedings enable all the debtor's property to be made available for his creditors.)

(8) The giving of notice to creditors by the debtor that he has suspended, or is about to suspend, payment of his debts.

A petition presented by a creditor must be in respect of a debt or debts of at least £50, payable either immediately or at some certain future time (that is, it must be an ascertained or "liquidated" sum). Two or more creditors may join together to make up the £50.

RECEIVING ORDER

If the Court is satisfied that the debtor is indebted to the petitioner and that an available act of bankruptcy has been committed, it makes a Receiving Order. On the debtor's own petition, the Receiving Order follows automatically.

The Receiving Order is an interim order designed to secure control of the debtor's assets and to protect them for the benefit of his creditors. It has the effect of staying all proceedings against the debtor, thus depriving individual creditors of their right to pursue their own remedies against the debtor and ensuring, as far as possible, equitable treatment as between one creditor and another. It does *not*, in itself, make the debtor bankrupt, as it is still possible that all the liabilities will be paid in full or that the creditors will agree to a composition that will make bankruptcy unnecessary.

The making of a Receiving Order is advertised in the *London Gazette* and in a local newspaper and terminates the debtor's right to dispose of his assets, collect his book debts, and so on. All his property passes into the control of the Official Receiver, whose immediate concern is to protect the estate rather than to realize the assets. In particular, any debts owing to the debtor must be paid to the Official Receiver. For this reason all Receiving Orders are noted and published in the appropriate trade journals, so that trade debtors and creditors at least have the earliest possible notice of the proceedings.

To enable the Official Receiver to take possession and control of the available assets the debtor must make a full disclosure of his affairs. To this end he is required to prepare and submit to the Official Receiver within seven days after the making of the Receiving Order (within three days if it was made on his own petition) a Statement of Affairs.

The Statement of Affairs is in the form of an affidavit; that is to say, the debtor is sworn to an oath that, to the best of his knowledge and belief, it is a full, true and complete statement of his affairs. The Official Receiver may, in suitable cases, extend the time limits allowed for completion of the statement; he may also allow an accountant to be employed (at the expense of the estate, subject to the payment of prior costs) to assist the debtor in the preparation of his Statement of Affairs.

MEETINGS OF CREDITORS

The first meeting of creditors is summoned for a day not later than 14 days after the date of the Receiving Order, unless this limit is extended by the Court. Its purpose is to consider whether a proposal for a composition or scheme of arrangement shall be accepted, or whether it is expedient that the debtor shall be adjudged bankrupt, and generally to consider the mode of dealing with the debtor's property.

In addition to attending the first meeting of his creditors, the debtor

is also summoned to a public sitting of the Court at which he has to submit to an examination into his conduct, dealings and property. Questions may be put to the debtor by the Court, the Official Receiver, the trustee (if one has been appointed) and by any creditor who has proved, or his representative authorized in writing. The proceedings are usually reported in the local Press.

SCHEME OF COMPOSITION

In a final effort to avoid bankruptcy the debtor may submit proposals for a "scheme of composition." It must be approved by a majority in number and three-fourths in value of the creditors who have proved and by the Court.

The Court has to consider whether the terms are reasonable and for the general benefit of the creditors, and takes into account the conduct of the debtor as brought out at his public examination and in a report from the Official Receiver. If the composition is approved, the Receiving Order is annulled and the bankruptcy proceedings, as such, are at an end. A trustee is appointed to carry out the terms of the composition.

ADJUDICATION

It has been seen that a Receiving Order does not, in itself, make the debtor bankrupt. Unless he can get the Receiving Order set aside or puts forward a scheme of composition which is accepted, the public examination of the debtor will be followed by the Court making an Adjudication Order.

The effect of this is to make the debtor bankrupt; his property now vests in a trustee for the purpose of being distributed amongst his creditors.

If, however, the Receiving Order is made on the debtor's own petition the Adjudication Order may be made at the same time.

An Adjudication Order can be revoked by the Court if a scheme of composition is subsequently sanctioned or if all the bankrupt's debts have been paid or secured, or in other circumstances where, in the opinion of the Court, the debtor ought not to have been made bankrupt. Notice of adjudication must be advertised in the *London Gazette* and in a local newspaper.

TRUSTEE IN BANKRUPTCY

The right to appoint a trustee of the bankrupt estate is enjoyed by the creditors who, by an ordinary resolution (that is, a resolution decided by a simple majority in value of the creditors present personally or by proxy), may appoint some fit person to that office.

The remuneration of the trustee is fixed by the creditors (or their representative Committee of Inspection) and must be in the nature of a commission or percentage, of which one part shall be payable on the amount realized by the trustee, after deducting any sums paid to secured creditors out of the proceeds of their securities, and the other part on the amount distributed in dividend. This rule is, of course, designed to ensure that the personal interest of the trustee and the interests of the unsecured creditors coincide.

The trustee is required to give security for the due performance of his

obligations; this generally takes the form of a guarantee bond given by an insurance company.

With the consent of the creditors a trustee can resign at any time. He may also be removed by the Board of Trade on various grounds or by the creditors at a meeting specially called for the purpose. If a Receiving Order is made against him, he vacates his office automatically.

Whether he resigns, is removed, or merely completes the realization and distribution of the estate, the trustee must apply to the Court for his release. Before this can take effect all books and papers in his possession relating to the estate must be handed over to the Official Receiver.

Where no trustee is appointed by the creditors, or pending such an appointment, or during any interval following the release of the trustee, the Official Receiver acts as trustee of the estate.

A committee of inspection, consisting of not less than three nor more than five creditors or their representatives, may be appointed by the creditors either at their first or at any subsequent meeting. Although the bankrupt's property vests in the trustee and he has complete and unfettered power to sell it and to distribute the proceeds in accordance with the Act, there are many other matters that may arise in the course of his administration upon which he has to take instructions from the committee.

For example, he must not carry on the business, bring or defend legal actions, employ a solicitor or other agent, mortgage or pledge the property, compound claims, or make an allowance to the bankrupt for assistance in winding up the estate, without the prior consent of the committee of inspection. The trustee therefore has the power to call meetings of the committee at any time, and in any case it must meet at least once a month.

If there is no committee of inspection, the Board of Trade, acting through the Official Receiver, must be asked to authorize such acts as require the authority of a committee.

DISTRIBUTION TO CREDITORS

Distribution of the available proceeds of realization is made, as regards unsecured creditors, in the form of a dividend at a certain rate in the £ on the amounts of their debts, as proved. Notice of a proposed dividend must be given to the Board of Trade so that it may be announced in the *London Gazette*; specific notice must also be given to every known creditor who has not yet proved his debt, allowing him not less than 14 days in which to do so. Many creditors do not go to the trouble and expense of proving their debts until they know that a dividend is about to be declared, in view of the large number of bankruptcies in which no dividend at all is paid.

Before any dividend can be paid to unsecured creditors the following prior payments must be met:

(1) Expenses actually incurred in realizing any of the assets.

(2) The costs of the proceedings.

(3) Pre-preferential and preferential creditors.

Care must also be taken in settling the list of creditors who have proved their debts and are entitled to rank for dividend, for the *rate* of dividend

payable will depend as much on the correctness of this list as on the funds available. A proof submitted by a creditor may be rejected by the Official Receiver or the trustee but the creditor may then appeal to the Court.

Interest at a rate not exceeding 5 per cent per annum, calculated up to the date of the Receiving Order, may be included in the proof of a debt which, either under the terms upon which it was to be contracted or by the operation of law (for example, in respect of an overdue bill of exchange), carried interest. Any interest agreed to be paid at a rate higher than 5 per cent cannot (in regard to the excess) rank for dividend until all other claims have been satisfied in full. Finally, where the assets are sufficient to meet all expenses and debts in full, all creditors (whether their debts originally carried interest or not) are entitled to interest at 4 per cent per annum calculated from the date of the Receiving Order.

SECURED CREDITORS

A secured creditor is one who holds a mortgage, charge or lien on the property of the debtor, or any part thereof, as a security for a debt due to him from the debtor. He will be a fully secured or a partly secured creditor according to whether the value of the property over which he has a charge exceeds or is less than his debt.

It will be noted that the security must be on "property of the debtor." If, therefore, the creditor has as security a charge on property belonging to some other person he is *not* a secured creditor for the purposes of the Bankruptcy Acts and can prove as an unsecured creditor for the full amount of the debt. For instance, where A has deposited investments with a bank, as security for an overdraft granted by the bank to B, the bank can prove for the full amount in B's bankruptcy.

PREFERENTIAL DEBTS

The following liabilities of a bankrupt are payable in full in priority to the claims of unsecured creditors:

(1) Local rates due and payable within 12 months before the date of the Receiving Order.

(2) Taxes assessed on the bankrupt up to April 5 next before the date of the Receiving Order, but not exceeding in the whole one year's assessment. Assessed taxes for this purpose include income tax under any schedule, land tax, profits tax, and excess profits tax.

(3) Purchase tax and P.A.Y.E. income-tax deductions becoming due within 12 months before the date of the Receiving Order.

(4) Wages and salaries of employees for a period not exceeding four months next before the date of the Receiving Order, subject to the total for any one claimant not exceeding £200, and accrued holiday pay.

(5) Contributions due under National Insurance Acts within 12 months next before the date of the Receiving Order.

(6) Certain claims in regard to Workmen's Compensation.

Where the assets are insufficient to meet all the preferential debts in full, they rank equally for dividend; in such cases, of course, the unsecured creditors can receive no dividend at all. In a few cases, however, it may be

necessary to meet certain pre-preferential debts in priority to those shown above. They are:

(1) The funeral and testamentary expenses of a deceased insolvent.

(2) A proportion of any premium paid by an apprentice or articled clerk whose apprenticeship or clerkship is terminated by the bankruptcy.

(3) Funds in the possession of an officer of a friendly society or a trustee of a savings bank, belonging to the society or bank.

(4) The expenses properly incurred by the trustee under a deed of arrangement which was avoided by the subsequent bankruptcy.

The rights of secured creditors are not affected in any way by the existence of preferential or pre-preferential creditors, whose claim lies against the estate as a whole rather than against individual assets.

The position of a landlord in the bankruptcy of his tenant is similar in some respects to that of a preferential creditor in that he has the right to distrain on goods or effects of the bankrupt. Bankruptcy does not take away this right but limits it to six months' rent accrued due before the date of the Adjudication Order. Any balance of rent outstanding over and above this amount will rank as an unsecured liability, as will the full amount if there are no effects upon which the landlord can distrain.

DEFERRED DEBTS

The following debts are deferred in the event of bankruptcy and cannot be met by the trustee until all preferential and ordinary unsecured liabilities have been paid in full:

(1) A loan by a husband to his wife or by a wife to her husband for use in a business carried on by the borrower. (Loans made between husband and wife for other purposes are not affected by this rule and rank as unsecured liabilities.)

(2) A loan by one person to another for the purpose of the latter's business or the sale of the goodwill of a business in return for a share of the profits or of a rate of interest varying with the profits.

(3) Claims under certain settlements which are voidable by the trustee.

RIGHTS OF TRUSTEE IN REGARD TO PROPERTY

All the rights which could have been enjoyed by the bankrupt himself in relation to his property pass to his trustee, who also acquires the following additional rights thereto:

(1) He may disclaim property to which onerous obligations are attached, such as leases, partly paid shares and unprofitable contracts.

(2) Under the doctrine of "relation back" the trustee's title dates back to the commencement of the bankruptcy, which, for this purpose, is the first act of bankruptcy known to have been committed within six months prior to the petition (and thus not necessarily the act on which the petition was founded). If in that period the debtor made any conveyance or transfer of his property other than for valuable consideration, or paid certain of his creditors with intention to prefer them, the trustee may be able to recover the property transferred or the money paid, for the benefit of the creditors as a whole.

(3) A voluntary settlement made by the bankrupt within two years before his bankruptcy, unless it was made in favour of a purchaser in good faith and for valuable consideration or was made before and in consideration of marriage. If the parties claiming under the settlement cannot prove that the settlor was solvent (without the aid of the property concerned) at the time of the settlement, the period of two years is extended to ten years.

(4) Under Section 38 (*c*) of the Bankruptcy Act, which is commonly known as the "Order or Disposition Clause," the trustee's title extends to "all goods being, at the commencement of the bankruptcy, in the possession, order or disposition of the bankrupt, in his trade or business, by the consent and permission of the true owner, under such circumstances that he is the reputed owner thereof." The most usual application of this provision is in regard to stock which the bankrupt has received from certain suppliers on "sale or return."

DISQUALIFICATIONS OF A BANKRUPT

From the date of his adjudication until he obtains his discharge the debtor is an undischarged bankrupt. During this period he is under certain disqualifications, namely:

(1) He cannot act as a director of any company except by leave of the Court by which he was adjudged bankrupt.

(2) If he is a peer he cannot vote in the House of Lords, and if he is a Member of Parliament he has to vacate his seat unless the disqualifications are removed within six months.

(3) He is liable to prosecution if he:

(*a*) either alone or jointly with any other person obtains credit to the extent of £10 or upwards from any person without informing that person that he is an undischarged bankrupt; or

(*b*) engages in any trade or business under a name other than that under which he was adjudicated bankrupt, without disclosing to all persons with whom he enters into any business transaction the name under which he was adjudicated bankrupt.

(4) Any property that he may acquire after the date of the order (known as "after-acquired property") passes to the trustee. This does not affect the validity of a transaction entered into by the bankrupt with any person dealing with him bona fide and for value if it is completed before any intervention by the trustee; the bankrupt may have to account to the trustee for the proceeds, however.

DISCHARGE OF BANKRUPT

A person who remained for ever subject to the disqualifications of an undischarged bankrupt could not be said to have been relieved from the burden of his liabilities. The bankrupt has the right to apply to the Court for his discharge and may do so at any time after the conclusion of his public examination.

On the hearing of the application the Court shall take into consideration a report of the Official Receiver as to the bankrupt's conduct and affairs and may:

(1) Grant or refuse an absolute order of discharge; or
(2) Suspend the operation of the order for a specified time; or
(3) Grant an order subject to conditions.

The Act lays down a large number of circumstances in which the Court may not grant an absolute discharge, but must choose whether to refuse it, suspend it for a period of not less than two years or until a dividend of not less than 10s. in the £ has been paid to the creditors, or require the bankrupt as a condition of his discharge to consent to judgment being entered against him for a certain sum (which he will then have to satisfy out of his future earnings or after acquired property).

The circumstances laid down include not only such offences under the Acts as are punishable by imprisonment but also such matters as failing to keep proper books of account, continuing to trade after knowing himself to be insolvent, failure to account for assets, rash and hazardous speculations, bringing frivolous or vexatious law actions or having previously been adjudged bankrupt or made a composition with his creditors.

BANKRUPTCY OFFENCES

A person who has been adjudicated bankrupt or against whose estate a Receiving Order has been made is guilty of a misdemeanour (which is a criminal offence) in each of a large number of circumstances set out in Part VII of the Bankruptcy Act.

These include the concealment of property, books and documents; omissions from his Statement of Affairs (unless he proves that he had no intent to defraud); destruction and falsification of books and records; obtaining goods on credit by false representation; pawning, pledging or disposing of property obtained on credit except in the ordinary course of business and without intention to defraud; and the like, and may have been committed within six months before the presentation of the petition.

The provisions of the Act regarding the bankruptcy offence of having failed to keep proper books of account were extended and strengthened in the Bankruptcy (Amendment) Act, 1926, and now stand as follows:

"Any person who has been adjudged bankrupt or in respect of whose estate a receiving order has been made shall be guilty of a misdemeanour, if, having been engaged in any trade or business during any period in the two years immediately preceding the date of the presentation of the bankruptcy petition, he has not kept proper books of account throughout that period and throughout any further period in which he was so engaged between the date of the presentation of the petition and the date of the receiving order, or has not preserved all books of account so kept.

"Provided that a person who has not kept or who has not preserved such books of account shall not be convicted of an offence under this section—

"(*a*) if his unsecured liabilities at the date of the receiving order did not exceed in the case of a person who has not in any previous occasion been adjudged bankrupt or made a composition or arrangement with his creditors, five hundred pounds, or in any other case one hundred pounds; or

"(*b*) if he proves that in the circumstances in which he traded or carried on business the omission was honest and excusable.

"For the purpose of this section, a person shall be deemed not to have kept proper books of account if he has not kept such books or accounts as are necessary to exhibit or explain his transactions and financial position in his trade or business, including a book or books containing entries from day to day in sufficient detail of all cash received and cash paid, and where the trade or business has involved dealings in goods, statements of annual stocktakings and (except in the case of goods sold by way of retail trade to the actual consumer) accounts of all goods sold and purchased showing the buyers and sellers thereof in sufficient detail to enable the goods and the buyers and sellers thereof to be identified."

These stringent regulations were imposed in an effort to check what were known as "long firm" frauds, under which dishonest traders obtained substantial quantities of goods on credit, raised money quickly by selling them at prices which were often below cost, and lived on the proceeds without making any attempt to discharge their liabilities. As such persons rarely had any capital of their own in their "business" it is obvious that their liabilities never could be paid in full.

Bankruptcy proceedings, usually on their own petitions, would then ensue to "relieve them of the burden of their liabilities" and on obtaining their discharge the same procedure would be repeated. It is for this reason that the limit of £500 unsecured liabilities below which the section does not apply is reduced to £100 for a trader who has previously failed.

Honest traders who have kept proper books of account according to the principles of double entry have nothing to fear from these provisions; a trader who, without any dishonest motive, has failed to keep full accounts and records may, however, find himself in trouble.

PARTNERSHIP BANKRUPTCIES

It is a fundamental principle of partnership law (see Chapter VIII) that every partner in a firm is personally and fully liable for the firm's debts and obligations. A firm as such can for that reason never be insolvent unless all the partners are insolvent. Bankruptcy proceedings against a firm therefore involve the bankruptcies of all the partners in it. The bankruptcy of one of the partners in respect of his separate liabilities, on the other hand, does not involve the bankruptcy of the firm or of his co-partners; it does, however, dissolve the partnership in the absence of agreement to the contrary.

Since to constitute a firm there must be at least two partners, any partnership bankruptcy in a sense involves three or more separate bankruptcies, for it is necessary to deal separately with the estates of the firm and of each partner separately. The proceedings are consolidated as far as possible, however, and the same trustee (or the Official Receiver) acts in each estate.

Statements of Affairs have to be prepared for (1) the firm (the joint estate), and (2) each partner (the separate estates).

The principle followed in preparing these statements, and in the subsequent administration, is that the partnership liabilities are payable

primarily out of the partnership assets and each partner's personal liabilities are payable out of his separate assets. Any surplus in a separate estate is transferred to the joint estate for the benefit of the creditors.

DEEDS OF ARRANGEMENT

A Deed of Arrangement is a legal document under which a debtor comes to some arrangement with his creditors, usually in an effort to avoid bankruptcy proceedings which would otherwise be inevitable. It may take the form of an assignment of assets to a trustee, who is to realize them and distribute the proceeds among the creditors.

As, in the result, the creditors will usually receive less than 20s. in the £ on their claims, it is clear that no creditor can be bound by such an arrangement unless he assents to it. Further, as "an assignment of the debtor's property to a trustee for the benefit of his creditors generally" is one of the acts of bankruptcy upon which any creditor who has not assented to the deed may found a petition in bankruptcy, it is essential that all the principal creditors should assent to it.

To obtain the necessary consents, the creditors must be offered a better return than they would be likely to receive in bankruptcy. One factor which contributes to this is found in the lower scale of costs which will be entailed. It is also possible that friends or relations of the debtor will either put up a sum of money to help meet the claims on condition that bankruptcy proceedings are waived, or, alternatively, if they are already creditors for money lent to the debtor they may agree to withdraw their claims.

The decisive factor is often the personal credit of the debtor. If the creditors feel that his insolvency has been brought about by some exceptional period of trade depression or by other factors outside his control, they may accept a composition in the hope that it will enable him to avoid bankruptcy and continue his business to the ultimate benefit of all.

Although one of the aims of a Deed of Arrangement, as contrasted with bankruptcy, is to reduce legal formalities to a minimum, some measure of control is necessary in the public interest; this is found in the Deeds of Arrangement Act, 1914, and in the Deeds of Arrangement Rules, 1925, made pursuant to that Act.

The trustee under a Deed of Arrangement must render accounts to all creditors who assent to the deed. These take the form of a Receipts and Payments Account in the prescribed form and must be sent out at six-monthly intervals. Similar accounts, verified by affidavit, must be submitted to the Board of Trade at intervals of 12 months.

The accounts are not subject to audit unless a majority in number and value of the creditors so require.

LIQUIDATION

The liquidation of a company is not necessarily a matter of insolvency; it embraces the whole field of winding up such corporations. The law, which provides the means of creating an artificial person, or corporation, must also make suitable provision for its demise, in certain circumstances.

In particular, it must ensure that the respective rights of creditors, according to their various securities and preferences, and of members, are safeguarded. So far as companies incorporated under the Companies Act are concerned, the necessary provisions are now found in the Companies Act, 1948, and in the Rules made pursuant to that Act.

If the company is insolvent the procedure is analagous to that in bankruptcy in that liquidation can result either upon a creditor's petition or from a resolution of the company itself (which is equivalent to a debtor filing his own petition). In a large number of cases, however, there is no insolvency and all the creditors will be paid in full; liquidation is necessary because it is the wish of the members, or of the requisite majority of them, to bring the existence of the company to an end, either because the original purpose of the company has been fulfilled or for any other good reason.

Liquidation of an existing company may also become necessary because of some scheme of amalgamation or reconstruction under which the undertaking is to be transferred, as a going concern, to another company.

Except where liquidation results from the action of the creditors in petitioning the Court for a winding-up order, the control of the proceedings remains very largely in the hands of the company itself, although in every case a liquidator has to be appointed.

The Act deals with three main methods of liquidating a company:

(1) Winding up by the Court.
(2) Voluntary winding up.
(3) Winding up subject to the supervision of the Court.

Voluntary liquidations are divided into two distinct classes. known as "members' voluntary winding up" and "creditors' voluntary winding up," according to whether the company is solvent or insolvent respectively.

WINDING UP BY THE COURT

This type of liquidation is often called a "compulsory winding up" to distinguish it from a voluntary winding up. A company may be wound up by the Court if:

(1) the members pass a special resolution to that effect;
(2) default is made in delivering the statutory report to the Registrar, or in holding the statutory meeting, or the company does not commence its business within a year from its incorporation or suspends its business for a whole year;
(3) the number of members is reduced below the statutory minimum;
(4) the company is unable to pay its debts;
(5) the Court is of opinion that it is just and equitable that the company should be wound up.

VOLUNTARY WINDING UP

Any voluntary winding up is commenced by the action of the company itself in passing a resolution to that effect. A company may be wound up voluntarily:

(1) when the period, if any, fixed for the duration of the company by

the Articles expires, or the event occurs on which the Articles provide that the company is to be dissolved, and the company in general meeting has passed a resolution requiring the company to be wound up voluntarily;

(2) if the company resolves by special resolution that the company be wound up voluntarily;

(3) if the company resolves by extraordinary resolution to the effect that it cannot by reason of its liabilities continue its business, and that it is advisable to wind up.

It will be observed that only in the special and rather unusual circumstances defined in (1) will an ordinary resolution (that is, one passed by a bare majority of the members voting) suffice; in other cases either an extraordinary or a special resolution (both requiring a majority of three-fourths of the members voting) is required.

The use of an extraordinary resolution (which requires only 14 days' notice as compared with 21 days' notice of a special resolution) is restricted to cases where the liquidation is brought about by insolvency; this, then, is the normal method of commencing a creditors' voluntary winding up. Any voluntary liquidation, however, whatever the nature and wording of the resolution of the members, will be a creditors' voluntary winding up *unless* the directors have made and filed with the Registrar the "declaration of solvency" which is required to turn the proceedings into a members' voluntary winding up.

Any voluntary winding up commences at the time of the passing of the necessary resolution by the company; in a creditors' voluntary winding up, however, the meeting of the members at which this resolution is to be proposed has to be followed either on the same day, or on the day next following, by a meeting of the creditors of the company.

The first essential step in instituting a members' voluntary winding up is the directors' declaration of solvency. This is a statutory declaration made by a majority of the directors (with a minimum of two) to the effect that they have made a full inquiry into the affairs of the company and that in their opinion the company will be able to pay its debts in full within the period (not exceeding 12 months from the commencement of the winding up) specified in the declaration.

The declaration must have been made not more than five weeks before the date of the *passing* of the resolution for winding up and must be delivered to the Registrar of Companies for registration *before* the date of the meeting; it must embody a statement of the company's assets and liabilities as at the latest practicable date before the making of the declaration.

Severe penalties (including imprisonment for a period not exceeding six months) are imposed upon any director who makes the declaration without having reasonable grounds for the opinion expressed. If, in the result, the liabilities of the company are not paid or provided for in full within the period stated in the declaration, the onus is cast upon the directors to show that they had reasonable grounds for their opinion.

It may happen, however, that the assets fail to realize the amounts which the directors quite reasonably took into account in making their

declaration of solvency, or that for some other reason the liquidator finds that he will be unable to meet the claims of creditors in full. In that event he must forthwith summon a meeting of the creditors and lay before them a statement of the assets and liabilities.

LIQUIDATOR

The winding up of a company is normally entrusted to a liquidator, whose position is similar, in some respects, to that of a trustee in bankruptcy. The method of appointment varies according to the nature of the proceedings, being by the Court in a compulsory liquidation, by the creditors in a creditors' voluntary liquidation and by the members in a members' voluntary liquidation. His remuneration is fixed by the Court, the creditors or the members, according to the nature of his appointment.

The property of the company does not automatically vest in the liquidator, however, for the company retains its corporate status until the termination of the proceedings. The powers of the directors to deal with the business and property of the company cease and pass to the liquidator. Subject, in the case of a compulsory liquidation, to the sanction of the Court, he may carry on the business so far as may be necessary for the beneficial winding up thereof; this power would normally be used only where there appears to be a reasonable chance of disposing of the business as a going concern at a better price than would be obtained by selling off the assets piecemeal.

The liquidator must keep full accounts of his transactions and in a compulsory liquidation these are subject to audit by the Board of Trade.

In addition to his right to sell the property of the company, a liquidator has certain additional powers which are similar in principle to those enjoyed by a trustee in bankruptcy. Any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company within six months before the commencement of the winding up which, in bankruptcy, would constitute a fraudulent preference can be set aside.

Perhaps the most important extension of a liquidator's powers, however (and one which, from its nature, can have no counterpart in bankruptcy proceedings), is his right to upset a floating charge on the undertaking or property of the company if (1) it was created within 12 months of the commencement of the winding up, and (2) the company immediately after the creation of the charge was insolvent, unless and to the extent that cash was actually paid to the company at the time of or subsequently to the creation of the charge.

Thus, it is not possible for persons who have lent money to the company without security to cover themselves (at the expense of other creditors) by taking a debenture just before liquidation overtakes the company.

OFFICIAL RECEIVER

The functions of the Official Receiver in compulsory liquidations are similar to those which he exercises in bankruptcy. He takes control of the assets of the company until such time as a liquidator is appointed by the Court, and if no other person is appointed he acts as liquidator

throughout the entire proceedings. At the outset he receives the Statement of Affairs prepared on behalf of the company and submits a preliminary report to the Court. He takes no part in voluntary liquidations, however.

CONTRIBUTORIES

A contributory is a person liable to contribute to the assets of a company in the event of its being wound up. The members of a company limited by guarantee are liable in this way to contribute the sums specified in the Memorandum of Association of the company.

So far as a company limited by shares is concerned, liability as a contributory can arise only in regard to partly paid shares. No member whose shares are fully paid can be made liable for any further payment, whether on liquidation or otherwise.

CREDITORS

In a members' voluntary winding up the order in which the creditors are paid does not matter provided all claims are met in full. In any other case the proper priorities must be observed. These are the same as in bankruptcy except that:

(1) In compulsory liquidation the landlord's right to distrain for rent due is terminated by the making of the winding-up order and he thus becomes an ordinary unsecured creditor. Also, if distraint has been levied within three months before the date of the order the proceeds may be recoverable for the benefit of preferential creditors. In voluntary liquidations, however, the landlord's rights are not disturbed.

(2) Creditors who hold a floating charge on the company's assets are also subordinated to the claims of preferential creditors. Debenture holders normally have such a floating charge and in the event of liquidation (or when it becomes clear that liquidation is imminent) they may appoint a receiver to protect their interest. Control over the assets of the company may thus pass out of the hands of the liquidator into those of the receiver. Any surplus remaining after payment of the debenture holders' claims will be paid to the liquidator, however, and he will meet the claims of the unsecured creditors as far as possible out of this balance.

Secured creditors who hold a fixed charge on some one asset or assets of the company (for example, a mortgagee who has a mortgage secured on the company's freehold premises) are not affected by the rights of preferential creditors or debenture holders. As in bankruptcy, they will be either fully secured or partly secured according to whether their debt is less or more than the realizable value of the property on which they have a charge.

SHAREHOLDERS

If a surplus remains after discharging all known liabilities of the company the shareholders will be entitled to participate in it according to the rights attaching to their shares, as laid down in the company's Memorandum and Articles. This, of course, assumes that all the shares are fully

paid; if some are only partly paid, and the liquidator has not found it necessary to call up the balance in order to meet the claims of creditors, the amounts necessary to bring all the shareholders into line will be set off against their shares of the available surplus.

DISSOLUTION OF THE COMPANY

During the course of its liquidation a company retains its corporate status. It is therefore necessary that, at the conclusion of the liquidation, it should be formally dissolved. In a compulsory liquidation, when the affairs of a company have been completely wound up, the Court, if the liquidator makes an application, shall order that the company be dissolved.

At the conclusion of a voluntary winding up the liquidator makes up an account showing how the winding up has been conducted and the property of the company has been disposed of, and presents it to a general meeting of the company (and of the creditors in a creditor's voluntary winding up). A copy of this final account is filed with the Registrar. On the expiration of three months from the registration of this account the company is deemed to be dissolved unless the Court, on the application of any interested party, otherwise directs.

A company may get into a state where it is in nobody's interest to have it wound up formally. Subject to certain safeguards the Registrar has power to strike the names of such companies off the Register.

RECEIVERS

The right to appoint a receiver is found in the terms of the instrument (usually a debenture or debenture trust deed) in which a charge over assets of the company is given. Various circumstances, such as the failure of the company to pay the interest on the due dates, the making of a winding-up order (or the passing of a resolution for voluntary winding up), the levying of execution against the company's property, and the like, which indicate that the debenture holders' security is in jeopardy, give the right to appoint a receiver.

Where circumstances make such an appointment desirable but there is no power, in those circumstances, for the debenture holders to make the appointment themselves, then application can be made to the Court for a receiver to be appointed.

The powers of a receiver, as such, are restricted to protecting and realizing the assets for the benefit of the person(s) on whose behalf he is acting. If it is necessary for the business to be carried on for a time either for the purpose of selling it as a going concern or for the better realization of the assets, then a "receiver and manager" is usually appointed.

A receiver and manager appointed by the Court is usually given power to borrow up to a certain amount for the purpose of carrying on the business; this is essential where substantial amounts have to be paid out for wages and there are no liquid assets available.

Before the Companies Act, 1948, came into force a receiver appointed by debenture holders was usually, by the terms of his appointment, made

an agent of the company. This meant that while carrying on the business he might buy goods on credit and the company alone would be liable to pay for them; as the company was probably already insolvent this could result in an unsatisfactory state of affairs for the persons and firms who supplied the goods.

It is now provided that any receiver of the property of a company, however appointed, is personally liable on any contract entered into by him in the performance of his functions; he may, however, have a right of indemnity out of the assets.

STATEMENT OF AFFAIRS AND ACCOUNTS

Section 372 of the Companies Act, 1948, requires the company to submit a Statement of Affairs to the receiver within 14 days after he has given notice to the company of his appointment. This has to be in the form which is illustrated on pages 566 and 567.

The receiver shall within two months after receipt of the said statement send:

(1) to the Registrar of Companies a copy of the statement and of any comments he sees fit to make thereon, and a summary of the statement and his comments (if any); and to the Court (if he was appointed by the Court) a copy of the statement.

(2) to the company, a copy of his comments or a notice that he does not see fit to make any;

(3) to every debenture holder of whose address he is aware, and any trustees for the debenture holders, a copy of the summary of the statements and comments.

The receiver must make up an annual abstract of his receipts and payments (the first year commencing on the date of his appointment and the last account terminating on the date on which he ceases to act) and send copies to:

(1) the Registrar of Companies;

(2) the debenture holders and any trustees for the debenture holders.

The final account also shows the aggregate of his receipts and payments for the whole period of his receivership. In addition, a six-monthly abstract of receipts and payments must be filed with the Registrar of Companies, but this does not have to be circulated to debenture holders.

The remuneration of a receiver is fixed either by the Court, if he was appointed by the Court, or by the debenture holders, if he was appointed by them. If the company is in liquidation or goes into liquidation, however, the liquidator may apply to the Court to fix the remuneration of a receiver appointed by the debenture holders. The remuneration usually takes the form of a percentage on the amount realized.

PREFERENTIAL CREDITORS

The claims of preferential creditors in liquidation have priority over the claims of debenture holders under a floating charge created by the company. The receiver must, therefore, meet preferential claims in full before he makes any payment to debenture holders who have only a floating charge.

EXAMPLE ILLUSTRATING THE PREPARATION OF A STATEMENT OF AFFAIRS IN BANKRUPTCY

Owen Moore, of Oldtown, Mudshire, a printer whose financial position was already unsatisfactory, was defendant in an action for libel which resulted in the plaintiff being awarded £500 damages and costs. The damages not having been paid, and the necessary legal formalities having been completed, the Sheriff of Mudshire, at the suit of the plaintiff in the libel action, took possession of the goods in the defendant's business premises.

Moore consulted his solicitor and was advised to file his petition; this he did on April 1, paying a deposit of £10 to his solicitor for that purpose. A Receiving Order was made and the Official Receiver issued an authority for an accountant to be employed to assist the debtor in the preparation of his Statement of Affairs.

As Moore had kept a complete set of books it was possible to take out a Trial Balance as at April 1 from which the following Balance Sheet was drawn up:

OWEN MOORE

Balance Sheet as at April 1

	£	£		£
Mortgage	2,000		Freehold Premises at cost	2,500
Add Interest accrued	20		Plant and Machinery at cost less Depreciation	800
		2,020	Fixtures and Fittings at cost less Depreciation	200
Sundry Creditors		2,000	Motor Van at cost less depreciation	150
Bills Payable		400	Stock at cost	1,200
Bank Overdraft		1,200	Sundry Debtors	750
(*Note*. There is a contingent liability on bills discounted amounting to £250)			Cash in Hand	15
			Owen Moore, Capital A/c—Debit Balance	5
		£5,620		£5,620

In the past, accounts had been drawn up annually for the year ended June 30, the Official Receiver agreed to make July 1 preceding the date of the Receiving Order the commencing date for the purpose of the Deficiency Account.

The Profit and Loss Account for the period of nine months, July 1 to April 1, after providing for depreciation at the usual rates, revealed a net loss of £700. Moore's drawings from the business for the same period had amounted to £600 and the Balance Sheet prepared at June 30 had shown a credit balance of £1,295 on his Capital Account.

Note. The debit balance of £5 now appearing on the Capital Account can therefore, be reconciled as follows:

Net Loss from July 1 to April 1	£700
Drawings ,, ,, ,, ,,	600
	1,300
Less Capital Account Balance (Cr.) July 1	1,295
Capital Account Balance (Dr.) April 1	£5

The damages in the libel action and the costs, which amounted to £300, had not been recorded in the books. On the making of the Receiving Order the Sheriff relinquished possession in favour of the Official Receiver, but his costs, amounting to £10, rank as a first charge on the goods so released.

The mortgage is secured by a first charge on the freehold premises and the bank overdraft is secured by a second charge thereon and by a guarantee given by Moore's brother.

Included in Sundry Creditors is a liability of £70 to the X Garage for repairs to the motor van, which was in their possession at the date of the Receiving Order and upon which they claim a lien for their charges. Sundry Creditors also includes preferential creditors for rates, taxes, wages and so on, amounting to £200, and a loan from Owen Moore's wife, free of interest, amounting to £500.

One of the bills discounted is expected to be dishonoured by the acceptor, in which event it will rank for £100.

The realizable values of the assets are estimated as follows: Freehold Premises £3,000, Plant and Machinery £500, Fixtures and Fittings £50, Motor Van £100, Stock £1,000, Book Debts £100 bad, £200 doubtful (estimated to produce 50 per cent of their face value); the remainder are expected to be received in full.

The following private assets and liabilities, which are not reflected in the Balance Sheet, must also be taken into account:

> Life assurance policy for £1,000, the surrender value of which on April 1 was £130. On the preceding July 1 the surrender value was £100 and one premium of £45 had been paid on January 1.
>
> Furniture £100.
>
> His father's presentation gold watch inherited by him as an heirloom. The watch does not go, but is of considerable sentimental value. A brother has indicated that he will pay £30 to the estate for it.
>
> Liabilities at April 1 amounting to £80, including £30 due to the landlord of his dwellinghouse for one quarter's rent.
>
> The corresponding liabilities on July 1 are estimated to have been £40.

The £10 paid to the solicitor came out of the balance of cash in hand shown in the Balance Sheet.

The "top page" of the Statement of Affairs, ready to be sworn as an affidavit by Moore, and Sheet K, the Deficiency Account, will appear as set out on the following pages.

THE BANKRUPTCY ACTS, 1914 AND 1926.

In the OLDTOWN County Court.

IN BANKRUPTCY. No. of 19—

RE Owen Moore

To the Debtor.—You are required to fill up, carefully and accurately, this sheet, and such of the several sheets A, B, C, D, E, F, G, H, I, J, and K,(1) as are applicable showing the state of your affairs on the day on which the Receiving Order was made against you, viz., the 1st day of April 19—. Such sheets, when filled up, will constitute your Statement of Affairs, and must be verified by oath or declaration.

Gross Liabilities	Liabilities (as stated and estimated by Debtor).		Expected to Rank.	Assets (as stated and estimated by Debtor).		Estimated to produce.
£			£			£
2,980	Unsecured Creditors as per list (A.)		2,980	Property as per list (H.), viz.:—		
2,090	Creditors fully secured, as per list (B.)	£ 2,090		(a) Cash at Bankers		
				(b) Cash in hand		5
	Estimated value of securities	3,100		(c) Cash deposited with Solicitor for Costs of Petition		10
	Surplus	1,010		(d) Stock-in-Trade (cost £ 1,200)		1,000
				(e) Machinery		500
	Less amount thereof carried to sheet (C.)	980		(f) Trade fixtures, fittings, utensils, &c.		50
				(g) Farming Stock		
	Balance to *contra*	30		(h) Growing crops and tenant right		
				(i) Furniture		100
1,200	Creditors partly secured, as per list (C.)	1,200		(j) Life policies		130
				(k) Stocks and Shares		
	Less estimated value of securities	980	220	(l) Reversionary or other interests under Wills		
	Liabilities on Bills discounted other than Debtor's own acceptances for value, as per list (D.), viz.:—			(m) Other property, viz.:— Gold Watch		30
				Total as per list (H.)		1,825
	On Accommodation Bills as Drawer, Acceptor, or Indorser £			Book Debts as per list (I.), viz.:—		
	On other Bills as Drawer or Indorser £	250		Good		450
250	£	250		Doubtful	£ 200	
				Bad	100	
	Of which it is expected will rank against the estate for dividend		100		£ 300	
	Contingent or other Liabilities as per list (E.) £			Estimated to produce		100
	Of which it is expected will rank against the estate for dividend			Bills of Exchange or other similar securities on hand as per list (J.) £		
				Estimated to produce		
30	Creditors for rent, &c., recoverable by distress, as per list (F.)	£ 30		Surplus from securities in the hands of Creditors fully secured (per *contra*)		30
200	Creditors for rates, taxes, wages, &c., payable in full, as per list (G.)	200		£		2,405
10	Sheriff's charges payable under sec. 41 of the Act, estimated at	10		*Deduct* Creditors for distrainable rent, and for preferential rates, taxes, wages, sheriff's charges, &c. (per *contra*)		240
	Deducted *contra*	240		£		2,165
	(2) Surplus explained in Statement (K.)			(2) Deficiency explained in Statement (K.)		1,135
£6,760		£	3,300		£	3,300

I Owen Moore of 1 High Street, Oldtown in the County of Mudshire make oath and say that the above Statement and the several lists hereunto annexed, marked A, B, C, D, F, G, H, I, K and L, are, to the best of my knowledge and belief, a full, true, and complete statement of my affairs on the date of the above-mentioned Receiving Order made against me.

Sworn at..

in the County of......................................

this..................*day of* 19 .

Before me..

Signature ....

K. Deficiency (or Surplus) Account

	£	£		£	£
Excess of Assets over Liabilities on the (1) 1st day of July 19 (if any		1,485	Excess of Liabilities over Assets on the (1) day of 19 (if any)		
Net Profit (if any) arising from carrying on business from the (1) day of 19 , to date of Receiving Order, after deducting usual Trade Expenses			Net loss (if any) arising from carrying on business from the (1) 1st day of July 19 to date of Receiving Order, after charging against Profits the usual Trade Expenses		700
Income or profit from other sources (if any) since the (1) day of 19			Bad Debts (if any) as per Schedule "I" (2)		200
Gifts from relations and others			Depreciation of stock-in-trade	200	
Estimated profit on sale of freehold premises		500	" " machinery	300	
			" " trade fixtures, fittings, &c.	150	
			" " motor van	50	700
			Expenses incurred since the (1) 1st day of July 19 , other than usual Trade Expenses, viz., Household and personal Expenses of self and (3) wife and two children		595
(5) Deficiency as per Statement of Affairs		1,135	(4) Other Losses and Expenses (if any)— Liability on Bill Discounted expected to rank		100
			Damages in legal action	500	
			Costs (including plaintiff's costs)	300	800
			Sheriff's charges payable under s. 41		10
			Premium on life assurance policy	45	
			Less Increase in surrender value	30	15
			(5) Surplus as per Statement of Affairs		
Total amount to be accounted for	(6) £	3,120	Total amount accounted for	(6) £	3,120

NOTES.—(1) This date should be twelve months before date of Receiving Order, or such other time as Official Receiver may have fixed.
(2) This Schedule must show when debts were contracted.
(3) Add "wife and children" (if any), stating number of latter.
(4) Here add particulars of other losses or expenses (if any), including liabilities (if any) for which no consideration received.
(5) Strike out words which do not apply.
(6) These figures should agree.

Signature...............................

Dated......................19...

As indicated on the form itself, the Statement of Affairs has to be supported by detailed schedules. These not only show how the various totals are made up but also give full details, such as name and address of each creditor or debtor, particulars of the securities held by creditors, and so on. In the absence of detailed information, these schedules are not reproduced here, but the following notes show how certain figures in the Statement of Affairs and Deficiency Account are calculated.

(1) *Unsecured Creditors* (*List A*)

		£	£
Sundry Creditors as per Balance Sheet		2,000	
Less X Garage (List B)	£70		
Preferential (List G)	200		
		270	
			1,730
Bills Payable			400
Private Liabilities		80	
Less Landlord (List F)		30	
			50
Damages and Costs			800
			£2,980

(2) *Fully Secured Creditors* (*List B*)

	Amount		*Security*	*Surplus*	
Mortgage	2,020	Freehold	3,000	980	to List C
X Garage	70	Motor Van	100	30	to contra
	£2,090		£3,100	£1,010	

(3) *Excess of Assets over Liabilities, July* 1, (*List K*)

Capital Account (Cr. balance)	£1,295
Life Assurance Policy	100
Furniture	100
Watch	30
	1,525
Less Private Creditors	40
	1,485

(4) *Household and Personal Expenses* (*List K*)

Drawings from business	£600
Less Life Assurance Premium included therein	45
	555
Add Private Creditors, April 1	80
	635
Less Private Creditors, July 1	40
	£595

The following points may be noted as illustrating the more important general principles involved:

(1) The Statement of Affairs shows the position estimated to the best of the debtor's knowledge and belief, as at the date of the Receiving Order. It does not attempt to provide for the costs and expenses that will be incurred in the administration of the estate; nor, of course, is there any guarantee that the assets will realize the amounts stated or that there are no liabilities other than those disclosed.

Thus, although the statement shows a net total of £2,165 available to meet the claims of unsecured creditors it is most unlikely that that amount will be available for distribution in dividend.

(2) The unsecured creditors (List A) include the loan of £500 from

the debtor's wife which, being obviously for "use in his business," is a deferred debt in bankruptcy. The official form of the Statement of Affairs, which has been used here, does not provide for deferred debts to be shown separately.

In the absence of any other place in which to put it, it is included in total of Sundry Creditors.

(3) As the debtor was a sole trader, there is no distinction, in bankruptcy, between his private assets and liabilities and those arising in his business. It is, therefore, impossible to rely on the book figures (that is, the Balance Sheet) alone and the inclusion of the "private" amounts affects the opening surplus or deficiency as well as the position now disclosed.

(4) The right of the Official Receiver (and, subsequently, the Trustee, if one is appointed) to take possession of all the debtor's property, personal or private, as well as business assets, is further illustrated by the inclusion of the gold watch. This falls into the estate and its sentimental value can only be preserved by the action of some friend or relative in "buying it in."

If the watch had been left by Moore, deceased, in trust for Owen Moore, however, so that the latter had only a life interest in it, it would not pass into the bankrupt estate and would be excluded from the Statement of Affairs.

(5) The plaintiff in the libel action is a "judgment creditor" for £500, and costs, but this does not give him any preference or security; he ranks for dividend as an ordinary unsecured creditor. The fact that he had "levied execution" before the date of the Receiving Order does not improve his position as the execution had not been completed. The costs incurred by the Sheriff are, however, a preferential liability under Section 41.

(6) Bills payable are also included in the total of unsecured creditors; a bill of exchange is a negotiable instrument but not a security, since it does not confer a charge on any particular asset or assets. This assumes, of course, that the bills payable referred to in the Balance Sheet were all bills accepted by the debtor in settlement of various trade accounts; that is, they were acceptances for value. Had they been accommodation bills accepted for the benefit of some other party, for which the debtor had not received value, they would have been in the nature of a contingent liability and would appear in List D.

(7) The bills discounted do not appear as a balance in the debtor's books (see Chapter XIV); consequently, the amount which is expected to rank £100 has also to be entered in the Deficiency Account as a loss.

(8) The amounts appearing in the Deficiency Account as "depreciation" (stock £200, machinery £300, etc.) would be more correctly described as "estimated losses on realization." Depreciation, in the ordinary sense, has been provided for in striking the balance of trading loss for the year and the book values are at cost less depreciation. These may be fair enough as "going concern values," but the realizable values, with which the Statement of Affairs is concerned, will normally be substantially less.

(9) The item "household and personal expenses" in the Deficiency Account is not necessarily equal to the amount of the debtor's drawings from his business during the period. As in this example, adjustments normally have to be made for outstanding liabilities for personal expenditure both at the beginning and end of the period. Where personal assets (such as the life assurance policy in this example) appear it is necessary to consider whether and to what extent they have been acquired with money drawn from the business during this period.

ILLUSTRATION OF A STATEMENT OF AFFAIRS ON THE APPOINTMENT OF A RECEIVER

STATEMENT AS TO THE AFFAIRS OF NEARDONE NOVELTIES LIMITED ON THE 1st July, 1948, THE DATE OF THE APPOINTMENT OF THE RECEIVER, SHOWING ASSETS AT ESTIMATED REALIZABLE VALUES AND LIABILITIES EXPECTED TO RANK.

	Estimated Realizable Values £
ASSETS NOT SPECIFICALLY PLEDGED (as per List "A")	
Balance at Bank	
Cash in Hand	10
Marketable Securities	
Bills Receivable	
Trade Debtors	3,500
Loans and Advances	
Unpaid Calls	500
Stock in Trade	4,500
Work in Progress	
Freehold Property	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings, Utensils, etc.	7,000
Patents, Trade Marks, etc.	
Investments other than marketable securities	
Other property, viz. :—	

ASSETS SPECIFICALLY PLEDGED (as per List "B")	(*a*) Estimated Realizable Values	(*b*) Due to Secured Creditors	(*c*) Deficiency ranking as Unsecured (see below)	Surplus carried to last column
	£	£	£	£
Freehold Property	12,000	10,000		2,000
Marketable Securities	4,000	5,000	1,000	
	16,000	15,000	1,000	2,000

	£
Estimated surplus from Assets specifically pledged	2,000
ESTIMATED TOTAL ASSETS AVAILABLE FOR PREFERENTIAL CREDITORS, DEBENTURE HOLDERS SECURED BY A FLOATING CHARGE, AND UNSECURED CREDITORS*	17,510

(*e*) Gross Liabilities £	LIABILITIES (to be deducted from surplus or added to deficiency as the case may be)		
14,000	SECURED CREDITORS (as per List "B") to extent to which claims are estimated to be covered by Assets specifically pledged (item (*a*) or (*b*) on preceding page, whichever is the less) (Insert in "Gross *Liabilities*" column only.)		
600	PREFERENTIAL CREDITORS (as per List "C")		600
	Estimated balance of assets available for Debenture Holders secured by a floating charge, and Unsecured Creditors*		£ 16,910
10,200	DEBENTURE HOLDERS secured by a floating charge (as per List "D")		10,200
	ESTIMATED SURPLUS/DEFICIENCY as regards Debenture Holders*		£ 6,710
	UNSECURED CREDITORS (as per List "E") :—	£	
	Estimated unsecured balance of claims of Creditors partly secured on specific assets, brought from preceding page (*c*).	1,000	
	Trade Accounts	4,600	
	Bills Payable	800	
	Outstanding Expenses	300	
	Unsecured Loans	5,000	
	Contingent Liabilities (State nature) :—		
11,700	....		11,70u
	ESTIMATED SURPLUS/DEFICIENCY AS REGARDS CREDITORS* being difference between :	£	4,990 Def.
	GROSS ASSETS (*d*)	31,510	
£ 36,500	and GROSS LIABILITIES (*e*)	36,500	
	ISSUED AND CALLED-UP CAPITAL	£	
	..10,000..preference shares of....£1....each ....£1....called-up	10,000	
	.. 5,000..ordinary shares of....£1....each .... 10s...called-up	2,500	12,500
	ESTIMATED SURPLUS/DEFICIENCY AS REGARDS MEMBERS* (as per List "F")		£ 17,490 Def.

Summary of Gross Assets	(d) £
Gross realizable value of assets specifically pledged	16,000
Other Assets	15,510
Gross Assets £	31,510

*Notes

(1) (*f*) There is no unpaid capital liable to be called up *or*

(*g*) The nominal amount of unpaid capital liable to be called-up is £ 2,500 estimated to produce £ 2,000 which is/is not charged in favour of Debenture Holders — Strike out (*f*) or (*g*)

(2) The estimates are subject to costs of the Receivership and to any surplus or deficiency on trading pending realization of the Assets.

List "F"—Deficiency or Surplus Account

Statement of Affairs
List "F"

The period covered by this Account must commence on a date not less than three years before the appointment of the Receiver or, if the company has not been incorporated for the whole of that period, the date of formation of the company, unless the Receiver otherwise agrees.

	£	£	£
Items Contributing to Deficiency (or Reducing Surplus):			
1. Excess (if any) of Capital and Liabilities over Assets on the ....19.. as shown by the Balance Sheet (copy annexed)			
2. Net dividends and bonuses declared during the period from 1 July 1945 to the date of the Statement			500
3. Net trading losses (after charging items shown in the note below) for the same period			15,277
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars or annex schedule) Depreciation of investments			5,000
5. Estimated losses now written off or for which provision has been made for the purpose of preparing the Statement (give particulars or annex schedule)			10,213
6. Other items contributing to Deficiency or reducing Surplus : Calls in arrear estimated to be irrecoverable			500
			31,490
Items Reducing Deficiency (or Contributing to Surplus):			
7. Excess (if any) of Assets over Capital and Liabilities on the.. 1 July.. 1945 as shown on the Balance Sheet (copy annexed)	13,500		
8. Net trading profits (after charging items shown in note below) for the period from the..............19.. to the date of the Statement			
9. Profits and income other than trading profits during the same period (give particulars or annex schedule)			
10. Other items reducing Deficiency or contributing to Surplus: Estimated profit on realization of freehold property	500		14,000
Deficiency as shown by Statement		£	17,490

Note as to Net Trading Profits and Losses:

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this Account:—

	£	
Provisions for depreciation, renewals, or diminution in value of fixed assets	3,500	
Charges for United Kingdom income tax and other United Kingdom taxation on profits	1,000	
Interest on debentures and other fixed loans	1,500	
Payments to directors made by the company and required by law to be disclosed in the accounts	4,000	
Exceptional or non-recurring expenditure: Loss on realization of investments	9,000	
	19,000	
Less:—Exceptional or non-recurring receipts:—		
	19,000	
Balance, being other trading profits or losses	3,723	
Net trading profits or losses as shown in Deficiency or Surplus Account above £	15,277	Loss

Signature   Dated   19 ,

Note. This form of Statement of Affairs is laid down in the Companies (Forms) Order, 1948. A similar form is prescribed to be used in compulsory liquidation.

QUESTIONS AND EXERCISES

(Key to answers on page 572)

(1) What are (*a*) an act of bankruptcy; (*b*) an Official Receiver; (*c*) a Receiving Order?

(2) What meetings of creditors are normally held in the course of a bankruptcy? Who is entitled to attend and vote at these meetings?

(3) Outline briefly the powers and duties of (*a*) a trustee in bankruptcy; (*b*) a committee of inspection.

(4) Distinguish between secured and preferential creditors.

(5) What debts are known as deferred debts in bankruptcy?

(6) To what disqualifications is a bankrupt subject?

(7) What are bankruptcy offences? State briefly the provisions of the Bankruptcy Acts regarding the keeping of books of account.

(8) What are the principal advantages of a Deed of Arrangement as compared with bankruptcy proceedings, from the point of view of (*a*) the debtor; (*b*) unsecured creditors?

(9) In what respects does voluntary liquidation differ from compulsory liquidation. What are the two types of voluntary liquidation?

(10) What is a contributory? In the winding up of a solvent company what principles govern the distribution of the surplus assets?

(11) Distinguish between a receiver for debenture holders and a liquidator.

(12) How is a receiver for debenture holders appointed? Are the rights of preferential creditors affected by such an appointment?

(13) A Receiving Order was made against a debtor on September 30, 1948. The debtor's assets and liabilities were as follows:

	Book Values £	s.	d.
Assets—			
Land and Buildings	20,500	0	0
Trade Marks and Patents	12,216	1	5
Furniture	150	2	6
Stock	10,000	0	0
Bills Receivable	1,121	10	2
Book Debts	9,792	1	11
Liabilities—			
First Mortgage on Land and Buildings	18,000	0	0
Second Mortgage on Land and Buildings	6,000	0	0
Sundry Creditors	23,121	1	8
Bills Payable	2,090	1	2
Quarter's Rent unpaid	215	0	0
Preferential claims	218	3	11

Note. There was a contingent liability on Bills Discounted of £980 2s. 6d., of which £100 was expected to rank.

Trading results, after charging the debtor's "salary" of £100 per month, had been as follows:

Year ended September 30, 1947	Profit	£1,121
Year ended September 30, 1948	Loss	£4,023

The debtor had drawn from the business various sums amounting to £1,000 per annum in addition to his salary.

The debtor estimated that the Land and Buildings would realize £23,000, the Furniture £10, the Stock £8,000 and the Trade Marks and Patents £100. The Book Debts were considered good to the extent of £5,829 11s. 1d. and the remainder was estimated to realize 50 per cent.

Prepare a Statement of Affairs and a Deficiency Account as on September 30, 1948. (*Chartered Accountants, Inter.*).

KEY TO ANSWERS

The answers to the exercises are necessarily given in skeleton form and in most cases are designed merely to provide the student with an arithmetical check.

CHAPTER I

(1) See p. 8.

(2) See pp. 8 and 9.

(3) See pp. 9–11.

(4) See pp. 13–17.

(5) See pp. 11 and 12.

(6) See pp. 15 and 16.

(7) See pp. 14 and 16.

(8) (*a*) and (*b*) See p. 16. (*c*) Capital £1,114 1s. 6d., Net profit £456 1s. 6d.

(9) (*b*) Dr. balance £101 8s. 11d. (*c*) Brown is indebted to Smith.

CHAPTER II

(1) *Debits:* (*a*) Advertising, (*b*) Horses and Vans, (*c*) Discounts Received, (*d*) Plant and Machinery. *Credits:* (*a*) Repairs, (*b*) R. Dickson, (*c*) F. Williams, (*d*) B. Thomas.

(2) *Debits:* Discounts Received, Purchases, Purchases (£63), Shop Fittings (£37), Depreciation. *Credits:* A. Archer, Wages, B. Good, Machinery.

(3) *Debits:* Timber Suppliers, Ltd., Motor Lorries, Depreciation. *Credits:* Returns Outwards, Motor Lorries (£200), Cash (£300), Plant and Machinery.

(4) (*a*) Capital at Sept. 30, 1949, £426, Net Profit £300. (*b*) *Debits:* Cash at Bank £125, Cash in Hand £27, Stock £462, Debtors £107. *Credits:* Creditors £45, Loan £250, A. Trader Capital £426.

(5) *Debits:* Fixtures and Fittings, Drawings, Depreciation, J. Mills. *Credits:* Equipment Co., Purchases, Plant and Machinery, J. Field.

(6) Transactions with J. Frost: Goods sold to him, cash received from him, discount allowed to him, goods returned by him, and balance of £37 10s. written off as irrecoverable.

(7) *Debits:* Catchem & Co. £23 13s., E. Foster £1 1s., T. Jones £1 1s., Professional Charges £1 5s. 6d., Bad Debts £23 3s. 3d. *Credits:* A. Brown £5, E. Foster £10, T. Jones £8 13s., Catchem & Co. £3 7s. 6d., A. Brown £10 17s. 6d., G. Horwood £12 5s. 9d.

CHAPTER III

(1) See pp. 28–32.

(2) See pp. 30 and 31.

(3) See pp. 39 and 40.

(4) See pp. 40 and 41.

(5) Due from Customers £530, Stock £264 and Sales Returns £98 should be debits. Purchases Returns £264 and Creditors £628 should be credits.

(6) Dr. balance £21 3s. 9d.

(7) Cr. balance £102.

(8) (*b*) Debit entry: To discount disallowed £1.

(9) (*b*) *Real:* Bank, Petty Cash, Stock, Furniture and Fittings, Motor Vans. *Personal:* R. P. Herbert, A. C. Cole. *Nominal:* Light and Heat, Rent, Carriage on Sales, Purchases, Sales. (*c*) Dr. balances total £2,010, Cr. balances total £2,346.

CHAPTER IV

(1) See pp. (*a*) 43 and 47, (*b*) 48, (*c*) 11.

(2) Day Book totals: Total £1,246 8s., Linen £1,043, Cotton £203 8s.

(3) Day Book totals: Total £86 14s. 11d., Household Nuts £14 18s. 11d., Coke £52 17s. 1d., Anthracite £18 18s. 11d.

(4) Dr. balance £94 1s. 9d. Discount totals (Dr.) £6 2s. 6d., (Cr.) £1 11s. 3d.

(5) Post to Sales (Cr.), Discount (Dr.), J. Grant (Dr.), Rates (Dr.), Office Furniture (Dr.), Bank Charges (Dr.), Sales (Dr.).

(6) Corrected Cash Book balance £43 19s. (Cr.).

(7) Totals: (Dr.) Cash Received £25 17s. 1d.; (Cr.) Total £25 17s. 1d., Postage £5 10s. 4d., Stationery £1 11s. 2d., Carriage £1 12s. 7d., Travelling Expenses £1 1s. 1d., Office Expenses £1 1s. 11d.

(8) (*a*) Capital £1,273 18s. 10d. (*b*) Trial Balance totals £1,484 15s. 5d.

(9) Balances: (Dr.) F. Salter £58 10s., R. Rennie £36; (Cr.) Office Furnishings, Ltd., £76, Suppliers, Ltd., £142, M. Naseby £62, Packings, Ltd., £7.

(10) Cr. balances will exceed Dr. balances by £39 5s.

(11) Trial Balance totals £1,403 6s. 1d.

(12) Trial Balance totals £1,961 6s. 6d.

CHAPTER V

(1) See pp. 39 and 74.

(2) See p. 79.

(3) See pp. 78 and 79.

(4) See pp. 79–82.

(5) See p. 82.

(6) (*a*) Trial Balance totals £7,209. (*b*) Gross profit £1,672, Net profit £230. (*c*) Balance Sheet totals £3,658.

(7) Balances March 31: Capital (Cr.) £835 16s. 8d., R. Gilman (Dr.) £105 14s. 1d., Stock (Dr.) £209 7s., Furniture and Fittings (Dr.) £238.

(8) Missing debit is £307. Trial Balance totals £18,519. Cost of goods sold £4,750. Gross profit £4,120 (46·4 per cent).

(9) Gross profit £670 19s., Net profit £356 15s.

(10) Balance Sheet totals: (*a*) £7,719, (*b*) £6,942.

(11) Gross profits: Dept. A £19,659 15s. 5d., Dept. B £9,552 7s. 7d., Total £29,212 3s.

CHAPTER VI

(1) See pp. 89 and 90.

(2) See p. 89.

(3) See pp. 90–99.

(4) See p. 97.

(5) See pp. 92 and 93.

(6) Depreciation £215 per annum. Balance Dec. 31, 1951, £2,070.

(7) Balances: Sinking Fund A/c nil, Investments nil, Machinery (Dr.) £6,000.

(8) Depreciation: 1943 £19, 1944 £31, 1945 £50, 1946 £75, 1947 £101. Balance Dec. 31, 1947, £554.

(9) Depreciation: 1943 £2,996, 1944 £2,539, 1945 £2,965, 1946 £3,405. Balances Dec. 31, 1946: Plant and Machinery (Dr.) £30,643, Renewal and Replacement Reserve (Cr.) £3,488.

(10) Balances Dec. 31, 1947: Policy (Dr.) £3,454, Provision for Depreciation of Quarry (Cr.) £3,454, Quarry (Dr.) £35,000.

(11) Depreciation £2,794 14s. 6d. Profit on sale £13 2s. 6d. Balance June 30, 1949, (Dr.) £16,219 18s.

(12) Balances Sept. 30, 1949: Policy (Dr.) £3,609, Leasehold Redemption Reserve (Cr.) £3,609.

CHAPTER VII

(1) (*a*) Transfers to P. & L. A/c 1948 £219 6s. 2d., 1949 £186 16s. 5d. (*b*) Profit for 1948 would be overstated and for 1949 understated by £7 5s.

(2) Transfers to P. & L. A/c: 1948 £64, 1949 £64. Balances Dec. 31, 1949, Dr. £4, Cr. £12.

(3) Transfers to P. & L. A/c: Bad Debts £14 1s. 10d., Reserve for Doubtful Debts £19 16s. 10d.

(4) Payments in advance: Rates £52 11s. 3d., Insurance £3 0s. 7d.

(5) (*a*) Write off to P. & L. A/c. (*c*) Net reduction in profit (after eliminating Dr. for Suspense A/c) £15 1s. 4d.

(6) £15,991 8s. 1d.

(7) Gross profit £4,322, Net profit £1,198, Balance Sheet totals £10,834.

(8) Manufacturing A/c balance £65,850, Gross profit £22,550, Net profit £11,380, Balance Sheet totals £70,810.

CHAPTER VIII

(1) See pp. 130 and 132.

(2) See p. 139.

(3) See p. 131.

(4) See p. 133.

(5) See pp. 137–139.

(6) See pp. 138 and 139.

(7) See p. 137.

(8) See p. 131.

CHAPTER IX

(1) Current A/cs: Evans £200, Taylor £300. Balance Sheet totals £7,660.

(2) Departmental net profits: Retail £278, Repairs £613. Capital A/cs: J. Baxter £767, D. Dexter £129. Balance Sheet totals £1,554.

(3) Capitals: Foxley £9,158 10s., Green £9,158 10s., Holiday £3,500. Balance Sheet totals £27,607 10s.

(4) Shares of net loss: Brown £105, Green £135, White £30. Current A/c balances: Brown £25 Cr., Green £135 Cr., White £10 Dr.

(5) Interest on drawings: Brown £18, Jones £10 4s. 2d., Casey nil. Shares of profit: Brown £865 8s. 4d., Jones £692 6s. 8d., Casey £137 1s. 8d. Current A/c balances: (Cr.) Brown £367 8s. 4d., Jones £332 2s. 6d., Casey £593 1s. 8d.

(6) Capital A/c balances: X £10,375, Y £5,250, Z £2,375.

(7) Capital A/c balances: Johnson £5,200, Brown £1,400.

(8) Shares of profit: J £849, K £600, L £161.

(9) Green: Interest on Loan £60, share of profit £876. White: share of profit £876. Gray: share of profit £900.

(10) Cost of production £52,668, Gross profit £12,472, Net profit £6,235. Current A/cs: Andrews £591 Dr., Brown £108 Cr. Balance Sheet totals £65,882.

CHAPTER X

(1) Amount due to A £6,800; to B £4,400.

(2) Loss on Realization £1,275. Amounts paid to C £2,950, D £2,625.

(3) Loss on Realization £318. Balances due to Long £2,841, Short £2,841.

(4) Capitals: Brown £8,390, Jones £7,260, Smith £2,000. Loan, Andrews £5,450. Balance Sheet totals £25,017.

(5) Profit on Realization: Evans £1,938, Smith £1,292. Cash paid to Evans £18,498, paid in by Smith £6,598.

(6) Balance due to A's Trustee £4,822 12s. 6d. Current A/c balances: B £119 11s. 3d., C £697 16s. 3d.

(7) Profit on Realization £6,300. Cash paid to Rhode £4,830, Cresset £14,100.

(8) Balance on Capital Suspense A/c, £5,133 1s., transferred to Henry and Peter in equal shares.

(9) Loss on Realization £12,000, shared equally by X, Y and Z. Cash payments to X £10,000, Y £3,000.

(10) Cash paid to John £6,424. Balance of Henry's Capital A/c £8,261.

CHAPTER XI

(1) See pp. 187 and 188.

(2) See pp. 188–190.

(3) See pp. 191 and 192.

(4) See pp. 193–195.

(5) See p. 195.

(6) See pp. 197 and 198.

(7) See pp. 201–203.

(8) See pp. 203–205.

(9) See p. 206.

(10) See pp. (*a*) 207, (*b*) 206, (*c*) 209, (*d*) 209 and 210.

(11) See pp. 212 and 213.

(12) See pp. 214 and 215.

(13) See p. 216.

(14) See pp. 215–218.

(15) See pp. 219 and 220.

(16) See pp. 223–226.

(17) See pp. 222 and 223.

CHAPTER XII

(1) Issued share capital £388,750. Calls in Arrear £10,000. Calls in Advance £1,250. Cash at Bank £280,000.

(2) Journal entries include Goodwill (Dr.) £4,000, Premium on Shares (Cr.) £7,500, Discount on Debentures (Dr.) £500, Cash payment to vendors £53,000.

(3) Issued share capital £150,000. Premium on forfeited shares reissued £350.

(4) (*a*) Undistributed profit to June 30, £510 (net profit £2,010 less drawings £1,500), transferred to credit of Goodwill. (*b*) Jones owes Smith £130.

(5) Cash balance £18,675. Balances arising from journal entries: Share Capital (Cr.) £79,300, Forfeited Shares A/c (Cr.) £375.

(6) Balances arising from journal entries: Capital Redemption Reserve Fund (Cr.) £7,000, Ordinary Share Capital (Cr.) £3,000. Excess of Premium on Redemption (£1,250) over Premium on Shares (£600) is written off to P. & L. A/c.

(7) Issued Capital £91,250. Fixed Assets £55,800. Current Assets £83,100. Balance Sheet totals £138,900.

(8) Cr. balance on Investments A/c, £1,148, transferred to Sinking Fund A/c. Final Cr. balance on Sinking Fund A/c, £15,338, transferred to General Reserve.

(9) Discount written off in successive years: £2,000, £1,600, £1,200, £800, £400. Journal entries include £1,200 Debenture Discount written off and £20,000 transferred from P. & L. Appropriation A/c to Reserve.

(10) See pp. 265 and 255.

(11) Balances: (Cr.) Unclaimed Dividends £532 11s. 6d., Dividend A/c No. 23 £132 10s. (Total £665 1s. 6d. appears in Balance Sheet as unclaimed dividends). (Dr.) Bank Deposit £532 11s. 6d., Dividend No. 23 Bank A/c £132 10s. (merged with other bank balances in the Balance Sheet).

(12) Balances: Ordinary Share Capital (Cr.) £400,000, P. & L. A/c (Cr.) £10,000.

CHAPTER XIII

(1) See pp. 279–286, 289.

(2) See pp. 292–294.

(3) See pp. (*a*) 272 and 273, (*b*) 273 and 274, (*c*) 312.

(4) Balance c/f £37,750. Net dividend (£8,250) grouped with current liabilities.

(5) (*a*) £35,700; (*b*) £3,074 10s.; (*c*) £35,700, £2,400, £38,100, £6,005, £3,074 10s., giving a book value of £29,020 10s.

(6) Gross profit £85,870, Net profit £3,140 (after taxation). Transfer to General Reserve £628, Balance c/f £1,292. Balance Sheet totals £126,495 (Fixed Assets £64,800, Current Assets £55,695, Revenue Reserves £11,920, Current Liabilities £14,575).

(7) Net profit (subject to tax) £29,847. Taxation £12,025, Balance c/f £3,290.

(8) Gross profit £16,714, Net profit £9,139. P. & L. A/c c/f £8,339. Balance Sheet totals £133,331.

(9) Gross profit £22,117. Net profit £15,068. P. & L. A/c c/f £10,943. Balance Sheet totals £126,494. K Development A/c £5,445.

CHAPTER XIV

(1) See pp. 323 and 324.

(2) See pp. (*a*) 336, (*b*) 335.

(3) See pp. 323 and 324.

(4) See pp. 329 and 330.

(5) See pp. 326–328.

(6) Balance £369 15s.

(7) See pp. 342 and 343.

(8) See pp. 335 and 340 (discount on bill £2 3s., interest £15).

(9) Journal totals £236 18s. 11d.

(10) Cash book entries total (Dr.) £405 10s., (Cr.) £202 10s.

(11) Provide for doubtful debt in respect of balance on B's account £356 5s.

CHAPTER XV

(1) Balances: Bought Ledger (Cr.) £570, Sales Ledger (Dr.) £2,362.

(2) Balances: (Cr.) £14,517, (Dr.) £68.

(3) (*a*) Difference (excess of credits) 10s. (*b*) See p. 360.

(4) See p. 358.

(5) Postings to Nominal Ledger: Bad Debts £55 7s. 3d. (Dr.), £6 15s. (Cr.), Interest £1 5s. (Cr.), Bought Ledger Control £24 10s. (Dr.), Sales Ledger (Town) Control £1 5s. (Dr.), £12 9s. 9d. (Cr.), Sales Ledger (Country) Control £60 12s. 6d. (Cr.).

(6) See pp. 354–356.

(7) (*a*) H–O excess credits £6 9s. 6d., P–Z excess debits £6 9s. 6d. (*b*) A–G excess credits 19s. (*c*) Trial Balance—excess credits £9 1s.

(8) Postings to Control A/cs: Sales Ledger £2 2s. 9d. (Dr.), £122 7s. 9d. (Cr.), Bought Ledger £19 15s. (Dr.).

(9) Cash Book balances (Dr.): Cash £25, Bank £770 3s. 4d. Control A/c balances: Debtors (Dr.) £1,894 6s. 9d., Creditors (Cr.) £985 17s. 3d.

CHAPTER XVI

(1) Net profit £301. Balance remitted by ET & Co. £801.

(2) Net profit £67 6s. Balance remitted by Scott £367 6s.

(3) Net profit £405 13s. 1d. Sight draft (cheque) for balance £796 2s. 2d.

(4) Net profit £385, Stock £807 10s., Net proceeds £2,807 10s.

(5) July 14.

(6) Interest £72 5s. Credit balance £1,222 5s.

(7) Interest (Dr.) £36.

(8) Net profit £1,154. Balance due from B £3,935.

(9) Net profit (after charging loss on exchange £6 2s. 8d., Frs. 128.80) £246 17s. 4d., Frs. 5,184.20. Balance due from White £13 0s. 10d., Frs. 273.85.

(10) Profit £11,456 9s. 2d. Balance paid to Y £4,443 16s. 5d., received from R £1,583 12s. 7d.

(11) Net profit £622. Final payments from joint Bank A/c: Swift £3,736, Showman £581.

(12) Net Profit £1,130. Balance due from A to D £95 10s., from C to A £161.

(13) Interest (Cr.) £34. Balance due from Jones to Smith £520.

CHAPTER XVII

(1) See pp. 412–415, 418.

(2) FU £1,095, IR £1,450, PR £550.

(3) Gross profit £15,450. Net profit £8,166.

(4) Gross profit £220. Net profit £27.

(5) Gross profits: Car Sales £876, Petrol £251, Accessories £295, Repairs £1,394, Commission £104, Net profit £1,035, Capital A/c £4,913, Balance Sheet totals £5,042.

(6) Net trading profits: Head Office £4,343, Eastbourne £4,027, Worthing £2,888. Net profit for year £7,653. P. & L. A/c balance c/f £5,248. Balance Sheet totals £104,858. Balance on Head Office A/c in Worthing books £7,937, representing stock £4,332, debtors £3,572, cash £171 less creditors £119 and £19.

(7) Gross profits: Head Office £28,000, Branch £2,450. Net profit: Head Office £11,400. Net loss: Branch £600. Balance on Head Office—Branch A/cs (excluding goods and cash in transit) £9,750. Balance Sheet totals £56,850.

(8) Net profits: Head Office £1,213, Branch £3,069. Profit on exchange £429, Balance Sheet totals £48,086.

(9) Dr. Balance £5,827.

CHAPTER XVIII

(1) See pp. 442–447.

(2) See pp. 443–445.

(3) (*a*) Transfers to P. & L. A/c: 1947–48 £215 14s. 3d., 1948–49 £271 18s. 9d. (*b*) 1947–48 overstated by £10, 1948/49 understated by £10.

(4) See pp. 447–452.

(5) See pp. 454 and 462.

(6) See pp. 458–460.

(7) Interest Years (1) £19·39, (2) £11·18, (3) £2·43. Balance on Asset A/c, Dec. 31, Year (3) £174·08.

(8) Interest 1947–48 £40 17s., 1948–49 £27 18s., 1949–50 £14 5s. Depreciation 1947–48 £204 5s., 1948–49 £153 4s., 1949–50 £114 18s.

(9) £592 (to nearest £).

CHAPTER XIX

(1) Net profit £698.

(2) Net profit £200.

(3) Purchases £4,952 17s.

(4) Gross profit £7,575. Net profit £4,057. Balance Sheet totals £13,862.

(5) Net profit £880. Capital Jan. 1, £1,348; Dec. 31, £2,778.

(6) Stock destroyed: Bicycles £434, Wireless sets £815.

(7) See pp. 468 and 469.

(8) Profit on dances £83 17s. Excess of income over expenditure £63 1s. 2d. Balance Sheet totals £651 10s. 9d.

CHAPTER XX

(1) See pp. 498 and 499.

(2) See pp. 500 and 501.

(3) See pp. 508 and 509.

(4) See pp. 509–512.

(5) £16 1s. 10d. per article.

(6) 2s. 2d. per hour.

(7) Selling prices: Hand £14 12s. 10d., Electric £9 19s. 6d.

(8) (*a*) Variable costs 85 per cent, Fixed costs 10 per cent, Net profit 5 per cent. (*b*) Sales £14,000. (*c*) Net profit £1,200.

CHAPTER XXI

(1) See p. 525.

(2) See p. 527.

(3) See pp. 529–532.

(4) See p. 532.

(5) See pp. 531–534.

(6) See p. 534.

(7) See pp. 532–537.

(8) See p. 539.

(9) See p. 535.

(10) See pp. 534–537.

CHAPTER XXII

(1) See pp. 544 and 545.

(2) See pp. 545 and 546.

(3) See pp. 546 and 547.

(4) See p. 548.

(5) See p. 549.

(6) See p. 550.

(7) See pp. 551 and 552.

(8) See p. 553.

(9) See pp. 554 and 555.

(10) See p. 557.

(11) See p. 558.

(12) See pp. 558 and 559.

(13) Gross Liabilities £50,624 9s. 3d. Creditors expected to rank £26,311 2s. 10d. Deficiency £9,702 0s. 1d. Excess of assets over liabilities one year before receiving order £9,158 9s. 3d.

INDEX